

CHAPTER ONE

INTRODUCTION

1.1 General Background

Capital is considered to be the critical factor in economic growth and development and as such, occupies the central place in growth theories. This is more so in the case of under developed and developing economies like that of LDCs, which need to achieve a higher rate of growth of production for improving the living condition of majority of people. This requires that larger share of available resources viz. land and labor remain either unutilized or do not get their optimal use and hence cannot fully contribute to the production and national wealth creating process.

In the case of economic development of the country, more concern is granted to the financial and investment aspect of the economy. The biggest chunk of investment requirement in any economy is met from the resources generated by the economy itself. The internally generated resources come from the savings of the household, government, firms and companies. But countries with inadequate resources and poor performance may create serious problems. Today, efforts are being redirected towards the search for a new financial paradigm. The question that emerges is what alternative approaches should be followed for a more efficient financing of the productive sector. Sagari and Guidotti (1992), in IFC discussion paper on Venture Capital, explore one possible option, focusing on one narrow market segment: the financing of new operations or start-ups, and the financing of the expansion of existing operations in terms of advancing into new stages in the production and/or the distribution process. Normally firms at these stages have little or not enough cash flow to support debt obligations, high quality information on their activities and prospects may be impossible or very costly to obtain externally, and their level of capitalization is very low. All these factors create serious moral hazard problems that must be controlled by the outside investor, and that cannot adequately be dealt with through pure debt-type contacts. Within this context, the use of instrument which includes an equity feature is particularly important, since this would allow investors to better access information and to share in the results of exceptionally favorable outcomes in the form of cash flows or increased value of the enterprise affects. Yet typically, conventional equity financing will neither suitable nor available. Since the target investments are new ideas, companies, products, processes or services that lack a

performance history and will normally take a few years before positive cash flows are realized.

Venture capital practitioners claim to have found some answers to the peculiarities of the financial and managerial needs of such new operations through arrangements that involve essentially (Pratt: 1981):

- An equity participation of the outside investors via a direct purchase of stock, or through warrants, options or convertible securities,
- A long-term investment horizon, since nominally significant expected returns can only materialize after a period of between 5 and 10 years, and
- An active, ongoing involvement in the investor company.

Venture capital (VC) is one of the latest arrivals in the corporate financing. It is different from other common funding resources like equity capital and debt capital. It is generally considered as synonym of high risk capital. It is often thought of as “the early stage financing of new and young enterprise seeking to grow rapidly (Pratt: 1983). The volume of venture capital finance in developing countries has followed a steeply rising trend in recent years (Aylward: 1989). It usually implies an involvement by the venture capitalist in the management of the client enterprise. It has also come to be associated especially in USA, with the financing of high and new technology based enterprises. The conventional financiers generally support proven technologies with established markets. But high technology is not a necessary condition for venture financing (Pratt: 1983). The venture capitalist focuses on: he would like to see small business growing into larger ones.

Venture capital finance is intermediated external investment in small and medium-sized companies that offer the prospect of above average levels of investment risk. The investment process consists of raising fund, then screening, selecting and monitoring investments. Finally, investment must be sold and the capital repaid to investors (Aylward: 1989). VC plays a significant and strategic role in financing SSEs as well as medium and a large which incorporates generally with high technology and risky ventures. The VC activity is quite advanced in developed countries. Now, it has been exercising even in developing and less developed countries (LDCs). VC can be potential to become important sources for financing SMEs which do not have sufficient resources and retained earnings to invest but they have high growth potentiality.

At present, with rapid change in global perspective, a new concept of financing, i.e. venture capital financing has emerged and practiced resulting with several difficulties in transitional period in financing and investment sector. Although it is a recent innovation in financial sector, it is widely used in developed as well as developing markets of world economy. It can be an important factor for LDCs for economic development via joining hands by establishing multinational corporations and joint venture companies which helps in attracting foreign money and technology as well as uses of indigenous resources within the country. Therefore it is necessary to popularize and practice VC financing in developing countries like Nepal, which have financial, technological and managerial shortcomings but have prospect of above average earnings growth potential. Recently, Nepal is declared as federal democratic republic country by newly elected constitutional assembly. Nepal will be divided into different autonomous states, lot of innovation and capital investment should be done for restructuring of the states. For which VC financing is necessary. Considering this, the study relating to venture capital financing may be very rewarding.

1.2 Focus of the Study

The study relating to *Venture Capital Financing in Nepal* is extremely new in Nepal. Although the concept of venture capital financing is a recent phenomenon and is a significant innovation of twentieth century, now it is surprisingly increasing all over the world. Venture capital is widely practiced in developed countries and is spreading all over the world including underdeveloped and developing countries. Venture capital in Nepal is still in infancy. Therefore, research is focused on general to specific information about the VC financing with special emphasis on problem and prospect in Nepal. The study focuses on what may be the potential areas to practice VC financing and what types of partnerships, collaborations and agreements are to be done to promote VC financing in Nepal. The study also focuses what are the policies regarding foreign investments and technology transfer and if there is need to make amendment in policies regarding FDI and technology transfer and attracting foreign investment as well as advanced technologies.

1.3 Statement of the Problem

Capital or finance is considered one of the most critical factors for the growth of enterprise and the economic growth as well, and as such, occupies the central place in growth theories. This is more so in the case of under developed economies like that of Nepal, which need to achieve a higher rate of growth of production for improving the living standard of majority of

people. This requires that larger portion of available resources go for production purpose i.e. capital investment. Nepal has a growing number of potential new entrepreneurs with technical, managerial and innovative backgrounds, even though, low rate of internal savings and investment in companies to the national output has been the continuing characteristics of its economy.

Being a developing country, venture capital has a wider scope in Nepal. It can play a significant role in creating enterprises; developing existing enterprises and reviving sick industries. The small scale and the handicraft industries can also be helped by the venture capitalist.

Nepal, having a lot of the hilly regions suffers from creation of structural bottlenecks that inhibit the process of industrialization. Lack of adequate infrastructure; a meager capital base; hostile terrain; subsistence agriculture; the fragile ecology; small markets; lack of information on markets, products and appropriate technologies; apathy of banks towards first generation entrepreneurs; lack of collateral and guarantees; facilitating access to credit; lack of knowledge about how to grow enterprise; lack of managerial skills; lack of business exposure; and an unfavorable policy environment for SMEs, have led to limitations in government support and infrastructure. The government has a narrow attitude towards the industrial potential of such regions. In addition, socio-cultural factors resulting from the migrations of able-bodied youths in search of jobs reduce the entrepreneurial activity.

Despite the aforesaid social and physical constraints the Himalayan, hilly and terai-madhes regions in Nepal have certain inherent advantages in the field of rich natural resources like forest, water and minerals wealth, that offer a vast potential for income generating activities. There is several business opportunities based on local resources. Enterprises based on non-timber forest produce herbs and medicinal plants, sajeeban seeds used for production of bio-diesel, horticulture, floriculture, tourism (including internal and external tourism), electronics, software, textiles, biotechnology, handicrafts, adventures sports, micro-hydro electricity projects could easily be promoted by giving right kind of technology and human resources. For utilizing and mobilizing all other resources, the funding resources “Capital” become the most important and priority factor. There may be various ways of funding capital like equity capital and debt capital. But such types of capital only may not provide and support all kinds of resources and facilities to all type of business. Generally new and young investments have high risk and most of which are not yet profitable. Such business requires partnerships for

obtaining funds by issuing equity shares on quasi-private basis with management participants and for technical collaborations. This type of capital, venture capital, is provided generally by venture capital firms (VCFs) and sometimes by business organizations. A VCF is a professional financing organization that provides capital for ventures and generally assists the firm's management with expertise and strategic guidance (Ogden al; 2003).

Awashthi, Singh and Shrivastava in their article, *Promoting small and Micro-enterprises through the Training Interventions: The Indian experience*, have mentioned the various constraints of potential rural entrepreneurs.

- Low self image and lack of confidence.
- No faith in others, including friends.
- Who to contract to start a venture, what formalities and procedures are to be followed.
- No idea of business.
- How to know whether the business identified is a viable and sound proposition.
- How to manage the business?
- How to maintain accounting records?
- How to carryout cash and bank operations?
- Almost no technical skill

The study relating to Venture Capital Financing in Nepal is extremely new concept in Nepalese financing and investment sector and therefore several problematic factors relating to the study are as follows:

- Nepal is one of the least developed countries in the world. In this situation how can we attract the foreigners who are intended to extend their investment?
- Nepal now is going to be an active member of WTO. In this perspective how can we compete in terms of product, quality, market and technology with other developed countries, whereas we have lesser investment potentiality, lesser foreign investment participations and partners.
- Now the 21st century is the age of technology advancement. Nepal is a less developed country and technology used here are insufficient as well as inefficient to cater with

global market. But there is no well implication of VC financing that offers technology importation, technology transfer and technology advancement.

- Nepal is a country with rich resources but poor knowledge. There are no sufficient entrepreneurial, managerial, technological, marketing skills and ideas; they encircle all the activities in narrow segment. In this perspective, how it can be developed entrepreneurial, managerial and personal skills and technical knowledge without joining hands with foreign developers or competent entrepreneurs for optimum utilizations of local or indigenous resources.
- It is perceived that Nepal has financial shortage in terms of open investments in new and high-tech sectors but it has become necessary in these days. For this purpose it necessitates to encourage foreign investments in new and high technology oriented sectors.
- Foreign investors are entering here with their open hands expecting gains for long period and business expansion with investment security. For this purpose government should play helping role in terms of policymaking regarding foreign investment and that should be provided the trustful environment for investment. There is need of ample infrastructure developments. Now it is perceived insufficient as well as inefficient policies regarding foreign investment and technology transfer as well as vague regularity framework.
- In Nepal, industrialist and capitalist are fearful of investing in national level industries even if they are small, medium or high scale because there is no well practice of VC financing concept and they don't want to take high risk for uncertain gain. How can be mobilize the unutilized financial and other resources in terms of new and high technology oriented business that produce longer-term profits with business prosperity.
- There is lack of commitment and confidence within our domestic entrepreneurs and investors, which have segregated them from each other. But there is need of joining hands to each others with full confidence and high commitment for internal investment promotion and entrepreneurship development.
- There is no efficient capital market in Nepal. Many of the instruments of savings and investments easily available and commonly used in other countries are not available. The so-called "public enterprises" are in such a bad shape that they are incapable of raising resources from the retail investors (small savers). In this scenario, how the financing and investing activities can be operated other than attracting foreign investment. Nepalese investors also are capable of saving and investing, if they are provided with sufficiently secured investment options with good return prospects.

1.4 Objectives of the Study

1. To study the evolution of venture capital financing.
2. To popularize the generic idea and promotional efforts to increase the flow of application of the venture capital financing in Nepal.
3. To assess the trends in foreign investments projects as venture capital investment in Nepal.
4. To study the policy initiatives for the success of venture capital in Nepal.
5. To provide recommendations to the policymakers and researchers regarding venture capital financing base on the analysis and findings.

1.5 Limitation of the Study

The study has the following limitations:

- The study basically focuses on the conceptual and introductory aspect of the venture capital financing.
- This study is based on Nepalese perspective.
- This study mostly focuses on primary information through questionnaire.
- Some published data used in this study are historical. The trend line presented in the study is based on average value.
- Limited tools and techniques of financial analysis are undertaken.
- The study is based on random sampling and the study area mostly focuses on the Kathmandu valley.
- Only useful and significant percentage values have been undertaken in this study.
- The less knowledge about venture capital financing in most of the respondents is another important limitation of the study.
- The data from primary source i.e. from questionnaire is another limitation of the study.
- The study is to fulfill the partial requirement of MBS program and has to be conducted and submitted within the prescribed time.

Nevertheless efforts have been undertaken to present the latest data for the availability as far as possible. The study in some cases suffers from the lack of relevant data as sought on classified and sector-wise basis.

1.6 Plan of the Study

The research aims at undertaking the study in the following manner:

Chapter- 1

The present chapter incorporates the general background, focus of the study, statement of the problem, objective of the study, limitation and plan of the study.

Chapter-2

This chapter two is devoted with the review of literature. It includes concept, features, steps, and stages of VC financing, review relating to different fields, review relating to Nepalese perspective and concluding remarks.

Chapter-3

Chapter three deals with research methodology. It incorporates research design, nature and sources of data, population and sample study, data gathering instruments and procedures and method of analysis.

Chapter-4

This chapter deals with the presentation and analysis of relevant data and information. It includes an analysis of percentages, averages and trend analysis as per necessity.

Chapter-5

The final chapter summarize the whole spectrum of the study and offers recommendations for the improvement in future.

A bibliography and appendices have been incorporated at the end of the study. The annexes include the calculations of the ranking values, three yearly moving average values to show trend values and other informative measures.

CHAPTER TWO

REVIEW OF LITERATURE

2.1 The Conceptual Framework

Venture Capital (VC) is one of the latest arrivals in the corporate financing. It is quite advanced in developed countries. Now, it has been exercising even in developing as well as least developed countries (LDCs). Venture capital plays a strategic role in financing small scale enterprises and high technology and risky ventures. VC has potential to become an important source for financing of small scale enterprises (SSEs), which do not have sufficient resources and retained earnings to invest. Venture capitalists are playing a significant role in many developed and developing countries in the creation and development of enterprises.

2.1.1 Concept of Venture Capital

Technological change and development is very necessary for economic development. An 'idea' may be the brainchild of a scientist or an engineer or an inventor. But it is of no economic value at this stage as it needs to be transformed into a viable product. The most crucial input required for this process is finance. All developed countries and most developing countries have a well developed capital market and an excellent institutional framework for mobilizing funds for savers and making them available to investors for investment in business endeavors. However, funds are sanctioned only after a rigid appraisal of the past business record of the entrepreneur, the technical, economic and commercial viability of the project and so on. This exercise ensures the safety of funds. This is where the case of an entrepreneur with an innovative, unproven idea weakens. He cannot boast of a proven track record and running yield from the enterprise, thus, traditional financing institutions like commercial banks feel shy of parting with funds for enterprises under consideration, which do not have predictable returns and whose future is dogged by extreme uncertainty. The difference lies in one entrepreneur approaching a financial institution for funds to make paracetamol using the conventional 16-stage process and another entrepreneur wanting to make the same product using a new but untried 8-stage process. The funding agency will be readily forthcoming in the first case but raise eyebrows for the second because it is 'risky'.

This situation brings forth an urgent need for a financial instrument which would address itself exclusively to the innovation intensive and indigenous technology based enterprises

alone. Venture capital is one such instrument which has to occupy a significant place in the financial system by making profitable commercialization of technical innovations a reality. It has become famous during the past 2-3 decades as the lubricating oil which makes high technology enterprises run smoothly. The most appropriate examples are the Apple personal computer and Federal Express delivery service developed in the United States.

It is now time to dwell over the meaning and function of venture capital and its modus operandi. Since large institutional investors prefer less risky investments over small business type entrepreneurial investments, this leads to a 'capital gap' i.e. an inadequate supply of risk capital for entrepreneurial investments. Venture capital fills this void.

A venture capital company can be broadly defined as a financial institution which joins the entrepreneur as a co-promoter in a project and shares the risks and rewards of an enterprise. Due to this fundamental feature of risk sharing, venture capital is referred as 'risk' capital. In most cases a venture capital company or venture capitalist contributes equity in a project along with the original promoter. However, venture capital investment is not necessarily made in return for equity. It can be made in the form convertible debt, long-term loans and conditional loans. This implies that from the venture capitalists point of view, it is just as risky to provide unsecured debt capital to a small or medium size business as it is to provide equity. There is no tangible security in the form of corporate assets available as cover for credit. Proposals are presented before the venture capitalist, who appraises them bearing in mind the credentials of the founders, nature of the product or service to be developed and the viability of the specific project.

The concept of venture capital has been very vividly defined by Leo Barnes and Stephen Feldman in the Handbook of Wealth Management as follows:

“Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such young companies are chosen because of their potential for considerable growth due to advanced technology, new products or services or other valuable innovations. A high level of risk is implied in turn and is implicit in this type of investment, since certain ingredients necessary for the success of such projects are missing in the beginning but are added later”.

According to Pratt, VC refers to that capital which is provided to set up new firms with new ideas and technology. Venture capitalists provide skills and funds needed to set up the firm, design its marketing strategy, organize and manage it. Generally there are four stages of

firm's development – the development of an idea, start up, fledgling and those that are established. VC may be provided at each stage of the firm's development. VC represents funds invested in an existing, relatively new enterprise (Van Horne: 2004).

Venture capital (also known as VC or Venture) is a type of private equity capital typically provided to immature, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company. . A venture capitalist (VC) is a person who makes such investments. A venture capital fund is a pooled investment vehicle that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. Venture capital can also include managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. This form of raising capital is popular among new companies, or ventures, with limited operating history, which cannot raise funds through a debt issue. The downside for entrepreneurs (or upside if the founders are lacking in particular skills) is that venture capitalists usually get a say in company decisions, in addition to a portion of the equity (Wikipedia: 2007).

Venture capital (VC) is a significant innovation of the twentieth century. It is generally considered as a synonym of high risk capital. It is often thought of as “the early stage financing of new and young enterprises seeking to grow rapidly”. It usually implies an involvement by the venture capitalist in the management of the client enterprises. It has also come to be associated, especially in the USA, with the financing of high and new technology based enterprises. The conventional financiers generally support proven technologies with established markets. But high technology is not a necessary condition for venture financing. According to Pratt: “There is a popular misconception that high technology is the principal driving factor behind the investment decision of US venture capitalist. Only a small minority of venture capital investments are in new concepts of technology where potential technical problems add a significant amount of risk to the new business development”.

There is, however, no doubt that young, high tech companies would look forward to the venture capitalists for making risky capital available to them. In broad terms, venture capital is the investment of long-term equity finance where the venture capitalist earns his return primarily in the form of capital gain. The underlying assumption is that the entrepreneur and

the venture capitalist would act as ‘partners’. The true venture capital does not remain just confined to high technology; any risky idea could be financed by the venture capitalist. In fact, venture capital can prove to be a powerful mechanism to institutionalize innovative entrepreneurship. It is a commitment of capital, or shareholdings, for the formation and setting up of small scale enterprises (SSEs) specializing in new ideas or new technologies. The venture capitalist focuses on growth; he would like to see small business growing into larger ones.

The key terms found in most definitions of VC are: early stage or seed financing, high risk, high growth, value additions by venture capitals, long-term gain, and absence of security capital. Thus VC can be defined as (Pandey et al): Venture capital is an investment, in the form of equity, quasi-equity and sometimes debt-straight or conditional (i.e. interest and payable when the venture starts generating sales), made in new or untried technology, or high risk venture, promoted by technically or professionally qualified entrepreneur, where the venture capitalist

- Expects the enterprise to have a very high growth rate,
- Provides management and business skills to the enterprise,
- Expects medium to long term gains, and
- Does not expect any collateral to cover the capital provided.

Type of Venture Capital

Venture Capitalists can be categorized into three types:-

1. **Angel Investors** are investors such as wealthy friends and family who usually provide seeds capital to start up a company or businesses
2. **Limited Liabilities Companies** are investors who use their own internal cash within the companies to invest with entrepreneur, e.g. Business Venture Promotion, CitiCapital. This type of VC does not separate the funds and the Manager into two different entities
3. **Fund Structure:** This type of VC will have funds and managers in two separate entities, e.g. H&Q Asia Pacific, Prudential and Asian Direct. The fund-manager companies can manage more than one fund. The fund company will usually have

limited life of ten years. The funds are usually set up as either limited partnership or limited liabilities Company while the fund manager is either the general (managing) partner of the limited partnership or another limited liabilities company.

2.1.2 Features of Venture Capital

The main attributes of venture capital can be summarized as follows:

- **Equity participation:** Venture financing is actual or potential equity participation through direct purchase of shares, options or convertible securities. The objective to make capital gains by selling-off the investment once the enterprise becomes profitable.
- **Long- term investment:** Venture financing is a long-term illiquid investment; it is not repayable on demand. It requires long-term investment attitude that necessitates the venture capital firms (VCFs) to wait for a long-period, say 5-10 years, to make large profits.
- **Participation in management:** Venture financing ensures continuing participation of the venture capitalist in the management of the entrepreneur's business. This hands-on management approach helps him to protect and enhance his investment by actively involving and supporting the entrepreneur. More than finance, venture capitalist gives his marketing, technology, planning and management skills to the new firm. Furthermore, the basic features of successful venture capital operations according to the Sagari and Guidotti (1992) are as follows:
 - i. **Hands-on Approach:** The trend of the industry indicates that a key factor for success is the so called American technique of "hands-on management", the ability to add value to an investment by actively contributing to running the business. This is basically implemented through providing a non-executive director who advices on matters such as finance, staffing, marketing, product development, distribution etc.
 - ii. **High Growth Potential Investees:** The success of venture capital business is largely a function of finding projects that require a relatively small initial investment, but that have a very high potential for growth.

- iii. **Small Scale:** The two aspects commented above, hands-on approach and high growth potential investees, lead to a third feature of successful venture capital operations, i.e. small scale. There is easy entry into the business in small scale and it is easy to the venture capital manage to deal with the needed close supervision and monitoring of the activities of the investee firms.
- iv. **Skills:** The performance of VC funds is considerably dependent on the ability of the venture managers to (a) assess the growth potential of a new business and (b) ensure that the “new idea” is transformed into a success story.
- v. **Private Management/Ownership:** From the above it seems that governments and government owned institutions would generally not be a suitable base for venture capital funds. The characteristics of civil service and government employee may not be suitable for the entrepreneurship, flexibility and managerial skills needed in a venture capital firm.
- vi. **Long-term Investment Horizon:** Investors in venture capital firm must have a long term time framework generally 5 to 8 or 10 years.
- vii. **Two-tiered Organizational Structure:** In this type of organizational structures investors supply the financial resources but a management company hired for these purposes is responsible for all investment and divestment decisions.
- viii. **Large Inflow of Deals:** Typically not more than 5 percent of the deals that are presented for consideration by the venture capitalist reach negotiation stage. Consequently, venture capital activity will require a dynamic and business support economic framework.
- ix. **Management Remuneration Schemes:** Management remuneration schemes are most successfully based on low fixed payments combined with a significant participation in the profits deriving from the deals under each manager’s responsibility.
- x. **Availability of Exit Mechanisms:** Well functioning security markets provide a “natural” exit mechanism to venture capital investors. However, alternative methods of divestment, such as mergers, private placements, management buyouts and most importantly acquisitions, have been also widely utilized.

The venture capitalists management approach differs significantly from that of a conventional banker or a lender. The banker does not directly get involved in the operation and management of the company. He plays safe, keeps off management, remains passive and insists on security (collateral). Of course, when the banker's stake is very high, he may get his nominee appointed on the board of the company to safeguard his interests. The venture capitalist is also not exactly like the stock market investor who merely trades in the shares of a company without any relations with or knowledge of its management. In fact, venture capitalist combines the qualities of banker, stock market investor and entrepreneur in one. Venture capitalists are different from conventional financiers in many respects. Exhibit 2.1 draws the differences:

S.No.	Venture capitalist	Conventional Financier
1	He is risk taker like the entrepreneur.	He is a risk avoider as protection of funds is the prime responsibility of the financier
2	He acquires equity, a share of ownership and with it a share of risk. He does not eliminate risk but manages it through in-depth monitoring, assisting and directing his investee companies and through portfolio diversification. He considers himself a partner of the entrepreneur.	His objective is to eliminate risk by loaning money against collateral and ensuring debt repayment capacity.
3	He specializes in management services of which finance is a part. He understands the whole scope of business, from team-building through to operations.	He specializes in financial services and has nothing to do with management or marketing to clients.
4	He has extensive operating experience and provides entrepreneurs full hands-on support.	Such experience is not required at all.
5	He channels funds into the lowest tier of the market i.e. the emerging enterprise.	He avoids such situations of risk.
6	Venture capitalist injects an element of vitality and innovation into the business community.	The conventional financier is not equipped to provide support which new enterprises demand alongside investments.
7	He assists the flow of new investment opportunities by encouraging entrepreneurs, developing entrepreneurial infrastructure by establishing different types of venture funds.	He only assists in investments.
8	Provides promoters' capital gap.	Not always so.
9	Provides second-stage financing for full achievement of investee company's potential realizing of business opportunities.	Not always so.
10	Provides finance for turning around sick, potentially sick, but viable units.	Not always so.
11	Encourages entrepreneurial initiatives and innovations which accelerate business development and the pace of national economic growth.	Always helps achieve business development and economic growth.

Project Finance vs. Venture Capital

A clear distinction should be made between the type of projects that lend themselves to the use of project finance and those that require venture capital, in which the entrepreneurs are

experimenting with something totally novel, the success or failure of which is not easily measurable, such as investments in new technologies.

Those projects that are best suited to project finance can be expected to display a higher probability of positive though relatively modest results, whereas venture capital projects are characterized by results that are potentially attractive but have a much lower probability of success.

Venture capital has a number of advantages over other forms of finance, such as:

- It injects long term equity finance which provides a solid capital base for future growth.
- The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded by business success and the capital gain.
- The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.
- The venture capitalist also has a network of contacts in many areas that can add value to the company, such as in recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed co-investments with other venture capital firms when additional rounds of financing are required.
- The venture capitalist may be capable of providing additional rounds of funding should it be required to finance growth.

Venture capitalist and Entrepreneur

Besides finance, the other crucial input provided by the venture capitalist is management support. After making his investment, the venture capitalist leaves the entrepreneur free to manage his business, but monitors its progress closely with the aim of ensuring proper end-use or the funds invested. He does not insist on voting control but only require some oversight on the venture activity. This can be efficiently carried out by appointing a director on the company's board of the assisted firm and insist on reviewing financial and other reports on the performance of the venture at pre-determined intervals. The nominee on the board does not interfere in the day to day operation of the business but works with the management in a consultative capacity. This gives rise to a 'creative partnership' combining

the venture capitalists rich experience in the company formation process and the entrepreneur's management skills and detailed knowledge of the market or technology. The venture capitalist can size up the entrepreneur and figure out at the appropriate time what his strengths and weakness are. In time of crisis, when a venture gets shaky, say, if the technology fails or market demand falters, the venture capitalist can give some precious guidance. He may insist on the managers of the assisted company to change their strategy. If the original team of the managerial skill fails, the venture capitalist may bring in new talent and thus a change in management. However, this does not mean that he is to be feared and distrusted by the assisted company. He is basically an advisor and confident of the entrepreneur.

2.1.3 Stages of Venture Capital Financing

According to the Government of India (GOI) guidelines, the venture capital financing be confined to the enterprises fulfilling the following conditions:

- **Size:** Total investment should not exceed Rs. 100 millions.
- **Technology:** New or relatively untried or very closely held or being taken from pilot to commercial stage or which incorporates some significant improvement over the existing ones.
- **Entrepreneur:** Relatively new professionally or technically qualified, with inadequate resources or backing to finance the project.

However, these conditions do not apply if financial assistance is provided for the revival of sick units. Venture capital excludes financing of enterprises engaged in trading, broking, investment or financial services, agency or liaison work. Exhibit 2.2 shows the different stages of venture capital financing.

1. Early stage financing	<ul style="list-style-type: none"> • Seed financing for supporting a concept or idea. • R & D financing for product development • Start-up capital for initial production and marketing. • First stage financing for full-scale production and marketing.
2. Expansion financing	<ul style="list-style-type: none"> • Second stage financing for working capital and initial expansion. • Development financing for facilitating public issue. • Bridge financing for facilitating public issue.
3. Acquisition/buyout financing	<ul style="list-style-type: none"> • Acquisition financing for acquiring another firm for further growth. • Management buyout financing for enabling operating group to acquire firm or part of its business. • Turnaround financing for turning around a sick unit.

Source: Pandey, I.M. (2003), Financial Management

Van Horne (2004) has mentioned four stages of VC financing viz. seed money, start-up or first round financing, second round financing and third round financing or bridge financing or subsequent round financing. Sagari and Cuidotti (1992) have reported on their discussion paper titled *Venture Capital: Lessons from the Developed World for the Developing Markets* that there are three stages financing for project initiation, second operating stage, which focuses on monitoring management in order to anticipate possible problems and take actions to minimize losses, providing new rounds of financing and assisting the entrepreneur in the making the firm more professional. Finally in the third, exit state, the concentration is on how to exit from the investment.

The stages of VC financing vary with the situation and industry. It is quite possible for a company to go through all three stages of preliminary financing, or it could skip directly to

the first round. A more detailed discussion of each of the three stages of preliminary financing, and of the subsequent stages of financing, now follows.

Pre-seed Financing

- **The condition of the company:** At this phase, talk of a "company" is still premature. What usually exist are an immature idea and an incomplete management team, and there is no guarantee that the idea is technologically feasible or commercially viable.
- **Sources:** The preliminary financing in the first stage is obtained from individuals who are close to the entrepreneur and know him or her personally (family and friends), private investors who are not organized in investing institutions, or incubators.
- **Use:** The money is needed to support the development of the idea in order to promote the product at least to the stage in which its feasibility is proven and to write the business plan.

Seed Financing

- **The condition of the company:** At this stage, there already is a company with a basic team of managers and/or entrepreneurs and possibly also a demo and a basic business plan.
- **Sources:** Once the feasibility of the idea has been proven, capital can also be raised from private investors (angels) who specialize in preliminary investments and from entities who invest in companies in their early phases, such as incubators and specialized funds.
- **The financing process and the investors' involvement:** The process of raising capital from private investors is relatively short, since private investors do not require more than several weeks to reach a decision. However, the entrepreneur should be prepared to present his or her project repeatedly since he or she must try to reach as many investor groups as possible, be they angel clubs, angel associations, or key persons who can influence other private investors because they have faith in the former's ability to screen investments. If the investors are funds or associations of investors, the process takes the form of institutional financing, but this is still done in relatively short time frames. At this stage, investors are primarily involved in providing general advice.

A large amount of capital is channeled to this field, although the amounts are much smaller following the decline in capital markets, but due to the multitude of new ventures, many investors find it hard to evaluate all the business plans that are sent to them, and without a good reputation of the entrepreneurs, or referrals and assistance by outsiders, a startup's chances of obtaining financing are slim.

- **Use:** At this stage, the money is applied toward recruiting a broader management team and employees, completing the business plan, and developing the product to achieve a beta version that will operate at a beta site (a working model at the customer's facilities) or at least an alpha version (a fully operative preliminary model).
- **Risk:** At this stage, the risk of losing the investment is tremendous high, because there are so many uncertain factors. From research, we know that the risk of losing the investment for the VC-firm is around the 66.2% and the causation of major risk by stage of development is 72%. These percentages are based on the research done by Ruhnka, J.C., Young, J.E. (Journal of Business Venturing)

First-stage Financing

As mentioned above, the focus of many funds on seed financing has blurred the distinction between seed financing and first-stage financing. We shall, however, attempt to point out several characteristics of first-stage financing.

- **The condition of the company:** The conditions for an investment are generally the existence of a functioning company with a reasonable understanding of the market and a product under development (at least a working prototype). In the past it was customary to expect a product that is ready to be launched on the market, but in recent years this type of financing has been provided at earlier stages.
- **Sources:** The source of finance at this stage is usually venture capital funds.
- **The financing process and the investors' involvement:** An investment is usually made after a vigorous due diligence process, designed to corroborate the assumptions underlying the business plan submitted by the company, and after the signing of a detailed contract regulating the terms of the investment, the relationship between the shareholders, and the conditions of the fund's exit. On average, this process lasts between three and six months, and during its course entrepreneurs are required to dedicate many efforts to the capital-raising process while continuing the daily

management of the company. At this stage, investors (most of whom are, as mentioned above, venture capital funds) make important decisions for the company, supervise the development activities and the recruitment of employees, and monitor the management's performance closely. These investments are also made in consideration for shares in the company (usually preferred shares which confer priority in distributions at the time of dissolution).

- **Use:** First-stage financing is used to complete the development and commercialization of the product, to expand the managerial team, and to commence the marketing efforts, including recruiting an initial marketing team and sometimes also a sales team.
- **Concerns:** Although the vast majority of the funds dedicated to venture capital investments are directed at first-stage financing, a company wanting to raise capital from venture capital funds for this stage still faces many problems:
 - Lengthy investigations— Since at this stage the company is still risky, venture capital funds perform lengthy investigations into the existence of a market for the product and into the company's chances of successfully completing the development of its products (most of the investment in this stage is dedicated to R&D and to preparing the ground for a managerial and marketing infrastructure). The entrepreneur is assessed at this stage on his or her ability to recruit employees, meet operating targets (he or she is usually not yet required to meet sales targets), and to present the company's vision.
 - Structural and expensive changes— The introduction of institutional investors at this stage usually results in a structural leap in the company's management, for example, financial reporting and a full-fledged board of directors. This transition, which is made during the course of the negotiations for an investment contract, is lengthy and requires considerable managerial resources.
- **Risk:** At this stage, the risk of losing the investment is shrinking, because the uncertainty is becoming clearer. The risk of losing the investment for the VC-firm is dropped to 53.0%, but the causation of major risk by stage of development becomes higher, which is 75.8%. This can be explained by the fact because the prototype was not fully developed and tested at the seed stage. And the VC-firm has underestimated

the risk involved. Or it could be that the product and the purpose of the product have been changed during the development. These percentages are based on the research done by Ruhnka, J.C., Young, J.E. (Published in Journal of Business Venturing).

Second- and Third-stage Financing

- **The condition of the company:** A company seeking this type of financing must demonstrate that it has a marketing system, solid management, and existing or pending sales.
- **Sources:** The investors are usually funds, institutional investors, and corporate investors who invest in companies whose business is close to their own.
- **The financing process and the investors' involvement:** Second-stage financing is usually a long and tedious process which requires considerable managerial attention. On average, it starts about one year after the first-stage financing and is followed by a reduced involvement by the investors in the daily management of the business (although they will still require the achievement of certain goals).
- **Use:** The money is used for working capital to enhance the marketing system, buy fixed assets required to support the growth of a company in the stage of active production, and to expand its sales and support teams. The ultimate aim is to reach the stage of sales and typically lead the company to profitability.
- **Concerns:** At this phase in the company's life cycle, it usually enters the stage of marketing and sales. These activities require vast financial and managerial resources that often exceed those available internally to the company. Companies therefore find themselves facing the need to raise more capital immediately, shortly after they finish their first-round financing. In this state of affairs, the company's value for purposes of the second-stage financing has usually not risen substantially, and the need for a large amount of capital may result in a considerable dilution of the existing shareholders, who would rather see a leap in scale in the value of the company.
- **Risk:** At second stage, the risk of losing the investment still drops, because the venture is capable to estimate the risk. The risk of losing the investment for the VC-firm drops from 53.0% to 33.7%, and the causation of major risk by stage of development also drops at this stage, from 75.8% to 53.0%. This can be explained by the fact that there is not much developing going on at this stage. The venture is

concentrated in promoting and selling the product. That is why the risk decreases. At third stage, the risk of losing the investment for the VC-firm drops with 13.6% to 20.1%, and the causation of major risk by stage of development drops almost by half from 53.0% to 37.0%. However at this stage it happens often that new follow-up products are being developed. The risk of losing the investment is still decreasing. This may be because the venture rely its income on the existing product. That is why the percentage continuous drop. These percentages are based on the research done by Ruhnka, J.C., Young, J.E. (Published in Journal of Business Venturing)

Pre-IPO Financing

- **Sources and uses:** This round of financing is relevant to companies 12–18 months before an IPO. The amount raised depends on the company's needs until the IPO, and may range between several millions and tens of millions of dollars. The value of the company is derived from its anticipated value in the IPO. This round is usually designed to provide bridge financing until the IPO is completed. The investors in this stage are often passive investors who expect to sell their stakes after the IPO, and venture capital funds, which have already invested in the company. In recent years, they have been joined by private-capital divisions of large investment banks, mutual funds which also invest in the private sector, and other financial institutions such as insurance companies.

In the months preceding an IPO, many companies want to secure interim financing to reduce the uncertainty with respect to the timing of the IPO. Such interim financing, which is becoming more and more popular, reduces the company's dependency on the condition of the stock exchange when determining the timing of the IPO and allows the company to wait for the optimal timing. This interim financing allows investors who are deterred from investing in startups in their early phases to take part in promising private placements. This type of financing is sometimes provided by potential underwriters seeking priority or exclusivity in the role of underwriters for the company's upcoming IPO.

Along with direct investments in consideration for preferred shares, the private sector has in recent years exhibited a sharp trend toward issuing convertible debentures before an IPO. Such securities are issued both to groups of institutional investors and to commercial banks, which have recently been expanding their activities in this field.

- **Concerns:** Companies in need of bridge financing are companies which can demonstrate increasing sales and a well-functioning marketing system, but are not yet ready to go public for various reasons, such as the absence of past experience in a consistent growth in sales or unfavorable market conditions. However, these companies are growing and require ever-increasing investments to finance their high cash burn rate. In these situations, companies sometimes face the problem of having to raise capital with shareholders who object to being diluted other than according to a value that is close to the company's forecasted value in the IPO. Companies in this phase can sometimes receive financing from underwriters, with the disadvantage of having to make a long-term informal commitment in advance to a particular underwriter, thus losing their flexibility to choose the appropriate underwriter when the time comes to go public.
- **Risk:** At this final stage, the risk of losing the investment still exists. However, compared with the numbers mentioned at the seed-stage it is far lower. The risk of losing the investment the final stage is a little higher at 20.9%. This is caused by the number of times the VC-firms may want to expand the financing cycle, not to mention that the VC-firm is faced with a dilemma of whether to continuously invest or not. The causation of major risk by this stage of development is 33%. This is caused by the follow-up product that is introduced. These percentages are based on the research done by Ruhnka, J.C., Young, J.E. (Published in Journal of Business Venturing).

2.1.4 Suppliers of Venture Capitals

There are at least four types of suppliers of venture capital:

1. First, a few old-line, wealthy families have traditionally provided start-up capital to promising business.
2. Second, a number of private partnerships and corporations have been formed to provide investment funds. These organizations might raise capital from institutional investors, such as insurance companies and pension funds. Alternatively, a group of individuals might provide the funds to be ultimately invested with budding entrepreneurs. American Research and Development (ARD) which was formed in 1946, is the most well known early partnership.

3. Third, large industrial or financial corporations have established venture capital subsidiaries. However subsidiaries of this type appear to make up only a small portion of venture capital market.
4. Fourth, participants in an informal venture capital market have recently been identified. (W.E. Wetzel, “The informal venture capital market: Aspects of Scale and Market Efficiency” Journal of Business Venturing). Rather than belonging to any venture capital firm, the investors (Often referred as Angels) act as individuals when providing financing. Wetzel and others indicate that there is a rich network of angel continually relying on each other for advice. A number of researchers have stressed that, in any informal network, there is likely one knowledgeable and trustworthy individual who when backing a venture, brings a less experienced investors in with him.

2.1.5 Modalities of Funding

The extension of finance by VC funds to enterprises may have different modalities. VC conceptually being risk finance should be available in the form of equity or quasi-equity (Conditional or Convertible Loans). Once the venture capitalist has decided to finance a venture, the principal vehicle is preferred stock with an equity link. This link can be warrants to buy common stock of a nominal price or a conversion feature into common (Van Horne, 2004).

Venture capital is typically available in three forms in India: equity, conditional loans and income notes. Conventional loan is also quite popular source of funds made available by VC funds in India.

- i. **Equity:** Equity is the most desirable form of VC financing. It helps new enterprises since it puts no pressure on their cash flows as there is no obligation to pay dividends if the enterprise doesn't have liquidity. When a venture capitalist contributes equity capital, he acquires the status of owner and becomes entitled to a share in the shares of an enterprise with an intention to ultimately sell them off to make capital gains.
- ii. **Conditional Loan:** A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. VC funds generally charge royalty ranging between 2 and 15 percent; actual rate depends on

other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some VC funds give a choice to the enterprise of paying a high rate of interest (which could be well above 20%) instead of royalty on sales once it becomes commercially sound.

iii. **Income Note:** It is a hybrid security, which combines the features of both a conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

iv. **Other financing Methods:** Other financing methods may include:

Participating Debenture-that carries charges in three phases, in the start-up phase, no interest is charged; after attaining venture operations at minimum level, a low rate of interest is charged; and once the venture starts operating on full commercial basis, a high rate of interest is required.

Partially convertible debentures and cumulative convertible preference shares are another way of VC financing.

In developed countries like the USA and UK, VC funds are accustomed to using a wide range of financial instruments. They include

Deferred Shares-where ordinary share rights are deferred for a certain number of years.

Convertible loan stock-which is unsecured long-term loan convertible into ordinary shares and subordinated to all creditors;

Special ordinary shares- with voting rights but without a commitment towards dividends;

Preferred ordinary shares with voting rights and a modest fixed dividend right and a right to share in profit.

Mezzanine debt - is loan finance that is halfway between equity and secured debt. These facilities require either a second charge on the company's assets or are unsecured. Because the risk is consequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that from the principal lenders and sometimes a modest equity "up-side" will be required through options or warrants. It is generally most appropriate for larger transactions.

Venture capital funds abroad also provide conventional loans, hire purchase finance, lease finance and even overdraft financing but overall financial package is always tilted in favor of the equity component (Pandey, I.M., 2003).

2.1.6 Venture Capital Investment Process

The venture capital activity is a sequential process, which involves the following six steps:

- 1. Deal Origination:** A continuous flow of deal is essential for the venture capital business. Deals may originate in various ways: (a) referral system, (b) active search and (c) intermediaries. Under referral system, deals may be referred to VC firms by their parent organizations, trade partners, industry associations, friends etc. Another important source of deals is the active search through networks, trade fairs, seminars, conferences, foreign visits etc. A third source, used by venture capitalists in developed countries like USA, is certain intermediaries who match VC funds and the potential entrepreneurs.
- 2. Screening:** VC firm receives many more proposals for financing that it could or like to take up. In order to select the best venture and to save the time, before going for an in-depth evaluation, VCF carryout screening of all projects on the basis of some broad criteria like in terms of technology, or product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.
- 3. Due Diligence (Evaluation):** Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most venture capitalists ask for a business plan (for detail content of business plan see annex 1) to make an assessment of the possible risk and return on the venture. Business plan should explain the nature of the company's business, what it wants to achieve and how it is going to do it. The company's management should prepare the plan and they should set challenging but achievable goals. VCF carefully reviews all the features and details mentioned in the business plan. The main objective of the process is to divide whether or not to invest and if the answer is positive, information above how and how much to invest. Attention is focused on several areas, most importantly:

- A) Quality of the entrepreneur and the management team including commitment, integrity, drive, honesty, long-term vision, reputation, creativity, urge to grow, managerial skills, commercial orientation;
- B) Characteristics of the product including price, distribution, uniqueness, assessment of competitive edge allowing high profit expectations;
- C) Technology to be used and its vulnerability;
- D) Market potential.

The most important aspects determining whether a venture capitalist would allocate funds to a specific firm after performing the due diligence or evaluation process were clustered by the authors in five basic groups that involve.

- (a) Market attractiveness
- (b) Product differentiation
- (c) Managerial capabilities of the entrepreneur
- (d) Environmental threat resistance
- (e) Cash-out potential.

4. Deal Structuring and Pricing: Once the venture has been evaluated as viable, the venture capitalist and the venture company negotiate the terms of the deal, viz., the amount, form and price of the investment. This process of setting of arrangements negotiated between the entrepreneur and the venture capitalist in terms of capital structure, the processing of the deal and other terms of arrangement including warranties and covenants is termed as deal structuring. Covenants include the venture capitalists right to control the venture company and to change its management if needed, buy back arrangements, acquisition making IPO's, etc. Venture capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for a return commensurate with the risk, influence over the firm through board membership, minimum taxes, investment liquidity, right to replace management in case of consistent poor managerial performance, etc.

The pricing of a venture capital deal is the most controversial aspect of the negotiation. Pricing has to do with the total return expected to be received over the life of an investment and includes both current income (dividends and interests) and capital gains.

5. **Post-Investment Activities:** When the deal is structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also gets involved in shaping of the direction of the venture. This may be done via a formal representation on the board of directors, or informal influence in improving the quality of marketing, finance and other managerial functions. Premus study found that in the US over 97 percent of the independent firms and 95 percent of the corporate firms prefer close or frequent involvement with the management team. The degree of venture capitalists involvement depends on his policy.
6. **Exit:** Venture capitalists typically aim at making medium or long-term capital gains. They generally want to cash-out their gains in 5 to 10 years after the initial investment. They play a positive role in directing the company towards particular exit routes. There are four ways to exit from venture investments. These are:
 - a) Initial public offerings (IPOs)
 - b) Acquisition by another company
 - c) Purchase of the venture capitalists share by outside parties interested in acquiring venture backed firms.
 - d) Repurchase of venture capitalists share by the investee company.

Private placement (direct sale), public sale via capital markets (IPOs) are the mechanism for sale. The secondary, over the counter (OTC), market which specializes in the trading of shares of small companies plays a critical role in exit through IPOs and acquisitions. More details about the divestment mechanism follows in next section.

2.1.7 Valuing the Portfolio

All venture capitals need to value their portfolio at specified time interval in order to assess the capital appreciation in their portfolio or to know the status of their invested funds. The main reasons for periodic valuation are given as under:

- 1) To provide the information about the portfolios to the investors.
- 2) To assist the venture capital manager in making inter-firm comparison so as to enable them in taking timely corrective actions, if required.
- 3) To enable the assessment of the quality of the management of a venture capital firm.

Principles of Valuations

- a) The basis of valuation should be consistent from year to year.
- b) Standard accounting norms should be followed.
- c) The basis of valuation should be properly disclosed such as discount rate, price-earnings ratio etc.
- d) Conservative approach should be followed while valuing the portfolios.
- e) The valuation should be done category wise such as unquoted venture investments, unquoted developments investments and quoted investments.
- f) Valuation should be done with reference to particular point of time.
- g) Valuation should demonstrate future earning potential of the company and the past track record should be taken as the basis only.
- h) Valuations should be reviewed by a third party.

Equity and equity like instrument are broadly categorized into three categories for the purpose of valuation:

- i) Unquoted venture investments
- ii) Unquoted development investments
- iii) Quoted investments

The valuation methods for these investments are

- 1) The cost method
- 2) The equity method
- 3) Market based valuation methods

1) Cost Method

Under this method of valuation, the historical cost at which the equity holding is acquired is taken as basis of valuation. The actual cost paid to acquire the equity shares or consideration paid in kind in the form of assets or debt converted into equity is taken as the value of the investment. In this calculation, the unrealized gains are not taken into consideration. This is the simple method and does not give the fair value of the investment at any point of time.

2) Equity Method

Under this method, the breakup value of the investment is evaluated. This method may provide some tax benefits to the venture capitalists as the investments which are in the initial stages generally yield negative returns. However, this write down or reduction in the value of an investment may not be appropriate in most cases as the value of investment may eventually appreciate due to initial research work, product development etc. the benefit of which arises in the future years.

3) Market based Valuation Method

This method is based on the market value of the shares of companies listed at the stock exchanges. The method is divided into following three categories:

- i) Quoted Market Value Method
- ii) Fair Market Value Method
- iii) Other market related methods

Quoted Market Value Method

This method is based on market quotations and hence this method is applicable to those companies those companies whose securities are listed on a stock exchange or any other market such as OTC. The market value does not display the correct worth of the company because the effect of intangible assets, performance of the industry in which the company is operating, management capability and other qualitative factors are reflected in the market value of a share of the company. Sometimes the problem arises when the share of the investee company is infrequently trade as a result of which the market value is not readily available. Then the last traded price is taken as the basis and altered using appropriate discount rate.

Fair Market Value Method

Under this method, the fair price is taken as the basis of evaluation. It is price that would be agreed upon in an open and unregulated market between fully informed, knowledgeable and willing parties at arm's length without constraint. This method is used in the cases where market price is not available.

The valuation techniques used for this purpose are:

I) Earnings of the enterprise

II) Asset Values

Valuation based on earnings

From the earnings reported last time by the company, the adjustment on account of payment of tax, dividends to preference shareholder are accounted for and the net earnings are calculated. The earnings per share of the company are estimated and multiplied with the P/E ratio of the industry to arrive the share price of the company, hence the value of the company.

Valuation based on assets

Under this method, two criteria can be applied- fair value and open market. Fair value is appropriate when market value of company is independent of its profitability. Fair value represents the shareholder's proportionate ownership of the total value of the whole company whereas open market value refers to a price of the assets of the company which could be fetched or realized by negotiating a sale, provided there is a willing seller and the property is fully exposed to the market.

The method of valuation of portfolio differs in case of different equity investments namely Unquoted Venture Investments, Unquoted development investment and Quoted investments.

Unquoted venture investments

These investments include investments at seed, start up or initial stages and normally termed as immature investments. They should be valued at cost except in cases where the investment is to be written up or written down. The investment may be *written down* in the following cases:

a) The investee company is undergoing through serious operational problem.

- b) The actual operating results are significantly lower than projections made by the venture capitalist and therefore needs to be revalued on downside scale.
- c) If the company is valued at less than the original cost in a transaction involving third party, then the third party should have an arm's length relationship with the venture capital firm.

Where the written down valuation has been conducted, the investee company should be kept under constant watch and should be revalued on any development taking place in the company.

The investment may be *written up* in the following cases:

- a) If the actual operating results are significantly higher than the projected results than the valuations are to be carried on upside scale.
- b) If a third party having an arm's length relationship with the venture capital firm values the ventures at a significantly higher value while providing finance or for any other reasons.

However, a caution is to be exercised in writing up the valuations of the company and such a practice shall not be followed unless the company reports remarkable performance in terms of sales turnover, profits etc.

Unquoted development investment

Under this case, the investments do not have market which provides easy valuation to the investments. However, these investments include mature investments where exit can be easily made. The valuation would be done in the similar method as explained in case of Unquoted venture Investment.

Quoted investment

Under this, the job of valuation is easier as the market quotations are available. However, the mid market quotation should be used as the basis. The market rate can be altered using an appropriate discount rate which depends on the following:

- a) Size of the market
- b) Venture capital firm's holding relative to the public holding.
- c) Restrictions placed on selling the shares for a certain specified period i.e. shares in lock in period.

d) Time of exit i.e. if the exit is to be made in the near future than the lower discount rate should be used whereas if the time of exit is not in near future then the discount rate should be accordingly increased.

Valuation of Debt

The investments in form of debt from the venture capitalist include convertible and non convertible debt, fixed income securities, non-interest bearing securities etc. Debt investments are generally valued at cost. However, other methods such as amortized cost, market value or cost (whichever is lower), and some other market based methods are also used. The venture capital firms generally do not provide funds in pure debt rather prefers to provide in the form of convertible debt. The convertible debt can be valued at cost or can be valued using methods provided for equity valuation assuming conversion has taken place. A debt can also be valued on lower of the cost or market value method. However this approach though conservative in nature is not appropriate in case of venture capital firm as the investments made in the initial years are likely to yield negative returns and later on after the expiry of gestation period, turnaround takes place.

Under the amortized method of valuation, the value obtained on cost method is adjusted according to the period of maturity. The most appropriate method of valuation of convertible debt is market and fair value methods. The market value method is appropriate for the quoted convertible debt and the principles applicable to quoted equity investments would apply in such cases. Sometimes moving average method is applied to overcome the effect of any temporary fluctuations. Under this method, the average of the market values of investments at the end of a prescribed number of periods is used as the basis of valuation. The average value reflects the long term market value of the investment. In case of fair method of valuation of debt, the price is agreed in an open and unrestricted environment and the price is also based on degree of subjectivity.

The non convertible debt can be valued on the basis of coupon rate and the safety of getting returns in terms of timely payment of interest and the principal payment.

2.1.8 Disinvestment Mechanisms

The objective of a true venture capitalist is to sell off his investment at substantial capital gains. The disinvestment options generally available to venture capitalists in developed countries are the promoter's buyback, public issue, sale to other VCFs, sale in OTC market,

management buyouts etc. In USA, the venture capital industry, since its inception, had access to well developed, efficiently functioning capital markets, and later on, to well developed over-the-counter (OTC) stock market. The stock markets and OTC markets in a number of European countries and a few developing countries including India, Nepal are recent phenomena. So far, they have been using other avenues for disinvestment. These avenues, although help to produce significant profits to investors, yet they are considered second-best in comparison to the stock market disinvestment.

Buyback

The most popular disinvestment route in developing country is promoter's buyback. This route is suited to the developing countries' situation because it keeps the ownership and control of the promoter intact. The obvious limitation, however, is that in a majority of cases the market value of the shares of the venture firm would have appreciated so much after some years that the promoter would not be in a financial position to buy them back. The venture capitalist enters into agreement with the promoter to offload the shares of the investee at a predetermined price after a certain specified period of time. The price at which the deal will be made can be either predetermined with put option or may be negotiated at the time of exercise of put option by the venture capitalist. A 'put' is the right of the venture capitalist to require the entrepreneur to buy the equity of the venture capitalists in the company on the basis of a predetermined formula. On the similar lines, the investee company may have 'call' option to buy the equity owned by the venture capitalist at a price based on predetermined formula. The formulas used are book value method, price-earnings ratio, percentage of sales method, independent valuation or agreed price.

Initial Public Offerings (IPOs)

The benefits of disinvestment via IPOs route are improved marketability and venture as well as market control through public share participation. This option has certain limitation. The promotion of the public issue would be difficult and expensive since the first generation entrepreneurs are not known in the capital markets. Further, difficulties will be caused if the entrepreneur's business is perceived to be unattractive investment proposition by investors.

Secondary Stock Market

An active secondary capital market provides the necessary impetus to the success of venture capital. VCFs should be able to sell their holdings, and investors should be able to trade

shares conveniently and freely. In US, there exists a well-developed over-the-counter (OTC) market where dealers trade in shares on telephone/terminal and not on an exchange floor. Such mechanism enables new, small companies to enlist on the OTC markets which are not otherwise eligible to be listed on the stock exchanges, and provides liquidity to investors. The National Association of Securities Dealers Automated Quotation System (NASDAQ) in USA daily quotes over 8000 stock prices of companies backed by venture capital. Recently, OTC exchange in Nepal was established.

Sale to other Venture Fund

Under this method, both the venture capitalist as well as the entrepreneur sells off their holding to some other individual or the enterprise. This is also known as 'trade sale'. The method of selling the enterprise may vary depending upon different situations:

- a) The venture capitalist and the entrepreneur may sell off their holdings against the cash to another individual but that would attract heavy tax burden. Therefore, they can opt for receiving some payment in form of cash; right at the time of sale and for the remaining payment either they can take notes secured against the assets of the company or the shares of the new company to which the venture is being sold. As a result of this process, the tax liability of the venture capitalist and the entrepreneur would get reduced.
- b) The venture capitalist and the entrepreneur can sell off their holding in the investee to another large corporate body or large industrial house and against that they can accept the share of the large corporate body or industrial house.

Exit in case of debt

In case of debt, the exit is normally achieved at the end of the maturity period. However, the venture capitalist if desires can negotiate or by way of agreement entered into with the entrepreneur may convert a part of the loan into equity at an earlier point of time. Where a conditional loan is provided, the venture capitalist can have exit well in advance. In such cases, the payment to be made to the venture capitalist can be negotiated with the entrepreneur for loan settlement.

2.2 Evolution of Venture Capital

The concept of VC originated in USA during the nineteenth and early twentieth century when the European investors along with American natives were involved in backing of construction

of new industries such as railways, steel, oil and glass. However, the earliest origins of venture capital can be traced back to the medieval period (1100-1400 A.D.) of Islamic mudaraba and musharaka financial system.

Mudaraba is in effect a partnership in which an entrepreneur (mudarib) is financed to undertake business and all profits are shared as prescribed in a contract but losses are to be borne solely by the financier (sahib almal). Under this mudaraba arrangement the financier is not allowed to participate in the management of the business but receives a specified percentage of the profit made on the business. The mudarib, or the entrepreneur, uses his expertise to achieve the profits, and is held responsible for poor performance only where deliberate negligence is established.

Under Musharaka, multiple investors pool resources in varying amounts and invest in a business project and receive a share of the profit (and losses) in proportion to their capital contribution to the project. The capital contributors are entitled to participate in the management of the joint venture financed, but this entitlement is seldom exercised. Usually, in musharaka the pooling of financial resources is done through an Islamic financial institution that offers deposit mobilization products to clients while selecting the enterprise to invest in. Depositors have a right to specify projects in which their money is to be invested and the location of the investment.

But, some venture capitalist said that the first Venture Capitalist was Queen Elizabeth of Spain in 1492 A.D. She invested in her entrepreneur, Christopher Columbus, to pioneer in exploring a new continent, America. In 1618 A.D, a group of wealthy individuals invested their money in three small companies which were set up to manufacture and distribute office equipment. The three companies were combined and called Computing Tabulating and Recording Co., Ltd, which later was changed to IBM.

With few exceptions, in US private equity in the first half of the 20th century was the domain of wealthy individuals and families. The Vanderbilts, Whitneys, Rockefellers and Warburgs were notable investors in private companies in the first half of the century. In 1938, Laurence S. Rockefeller helped finance the creation of both Eastern Air Lines and Douglas Aircraft and the Rockefeller family had vast holdings in a variety of companies. Eric M. Warburg founded E.M. Warburg & Co. in 1938, which would ultimately become Warburg Pincus, with investments in both leveraged buyouts and venture capital. Before World War II, venture capital investments (originally known as "development capital") were primarily the domain

of wealthy individuals and families. It was not until after World War II that what is considered today to be true private equity investments began to emerge marked by the founding of the first two venture capital firms in 1946: American Research and Development Corporation (ARDC) and J.H. Whitney & Company.

ARDC was founded by Georges Doriot, the "father of venture capitalism" (former dean of Harvard Business School), with Ralph Flanders and Karl Compton (former president of MIT), to encourage private sector investments in businesses run by soldiers who were returning from World War II. ARDC's significance was primarily that it was the first institutional private equity investment firm that raised capital from sources other than wealthy families although it had several notable investment successes as well. ARDC is credited with the first major venture capital success story when its 1957 investment of \$70,000 in Digital Equipment Corporation (DEC) would be valued at over \$355 million after the company's initial public offering in 1968 (representing a return of over 500 times on its investment and an annualized rate of return of 101%). Former employees of ARDC went on to found several prominent venture capital firms including Greylock Partners (founded in 1965 by Charlie Waite and Bill Elfers) and Morgan, Holland Ventures, the predecessor of Flagship Ventures (founded in 1982 by James Morgan). ARDC continued investing until 1971 with the retirement of Doriot. In 1972, Doriot merged ARDC with Textron after having invested in over 150 companies.

J.H. Whitney & Company was founded by John Hay Whitney and his partner Benno Schmidt. Whitney had been investing since the 1930s, founding Pioneer Pictures in 1933 and acquiring a 15% interest in Technicolor Corporation with his cousin Cornelius Vanderbilt Whitney. By far Whitney's most famous investment was in Florida Foods Corporation. The company developed an innovative method for delivering nutrition to American soldiers, which later came to be known as Minute Maid orange juice and was sold to The Coca-Cola Company in 1960. J.H. Whitney & Company continues to make investments in leveraged buyout transactions and raised \$750 million for its sixth institutional private equity fund in 2005.

It is commonly accepted that the first venture-backed startup is Fairchild Semiconductor (which produced the first commercially practicable integrated circuit), funded in 1959 by what would later become Venrock Associates. Venrock was founded in 1969 by Laurance S. Rockefeller, the fourth of John D. Rockefeller's six children as a way to allow other

Rockefeller children to develop exposure to venture capital investment. Venture capital investments, before World War II, were primarily the sphere of influence of wealthy individuals and families. One of the first steps toward a professionally-managed venture capital industry was the passage of the Small Business Investment Act of 1958. The 1958 Act officially allowed the U.S. Small Business Administration (SBA) to license private "Small Business Investment Companies" (SBICs) to help the financing and management of the small entrepreneurial businesses in the United States. Passage of the Act addressed concerns raised in a Federal Reserve Board report to Congress that concluded that a major gap existed in the capital markets for long-term funding for growth-oriented small businesses. Facilitating the flow of capital through the economy up to the pioneering small concerns in order to stimulate the U.S. economy was and still is the main goal of the SBIC program today. It was also in the 1960s that the common form of private equity fund, still in use today, emerged. Private equity firms organized limited partnerships to hold investments in which the investment professionals served as general partner and the investors, who were passive limited partners, put up the capital. The compensation structure, still in use today, also emerged with limited partners paying an annual management fee of 1-2% and a carried interest typically representing up to 20% of the profits of the partnership. The growth of the venture capital industry was fueled by the emergence of the independent investment firms on Sand Hill Road (in Menlo Park, California, where many Bay Area venture capital firms are based) beginning with Kleiner, Perkins, Caufield & Byers and Sequoia Capital in 1972. Located, in Menlo Park, CA, Kleiner Perkins, and Sequoia and later venture capital firms would have access to the burgeoning technology industries in the area. By the early 1970s, there were many semiconductor companies based in the Santa Clara Valley as well as early computer firms using their devices and programming and service companies. Throughout the 1970s, a group of private equity firms, focused primarily on venture capital investments, would be founded that would become the model for later leveraged buyout and venture capital investment firms. In 1973, with the number of new venture capital firms increasing, leading venture capitalists formed the *National Venture Capital Association* (NVCA). The NVCA was to serve as the industry trade group for the venture capital industry. Venture capital firms suffered a temporary downturn in 1974, when the stock market crashed and investors were naturally wary of this new kind of investment fund. It was not until 1978 that venture capital experienced its first major fundraising year, as the industry raised approximately \$750 million. With the passage of the *Employee Retirement Income Security Act* (ERISA) in 1974, corporate pension funds were prohibited from holding certain risky investments including

many investments in privately held companies. In 1978, the US Labor Department relaxed certain of the ERISA restrictions, under the "prudent man rule," thus allowing corporate pension funds to invest in the asset class and providing a major source of capital available to venture capitalists.

The public successes of the venture capital industry in the 1970s and early 1980s (e.g., Digital Equipment Corporation, Apple, Genentech) gave rise to a major proliferation of venture capital investment firms. From just a few dozen firms at the start of the decade, there were over 650 firms by the end of the 1980s, each searching for the next major "home run". While the number of firms multiplied, the capital managed by these firms increased only 11% from \$28 billion to \$31 billion over the course of the decade. The growth the industry was hampered by sharply declining returns and certain venture firms began posting losses for the first time. In addition to the increased competition among firms, several other factors impacted returns. The market for initial public offerings cooled in the mid-1980s before collapsing after the stock market crash in 1987 and foreign corporations, particularly from Japan and Korea, flooded early stage companies with capital. In response to the changing conditions, corporations that had sponsored in-house venture investment arms, including General Electric and Paine Webber either sold off or closed these venture capital units. Additionally, venture capital units within Chemical Bank and Continental Illinois National Bank, among others, began shifting their focus from funding early stage companies toward investments in more mature companies. Even industry founders J.H. Whitney & Company and Warburg Pincus began to transition toward leveraged buyouts and growth capital investments. By the end of the 1980s, venture capital returns were relatively low, particularly in comparison with their emerging leveraged buyout cousins, due in part to the competition for hot startups, excess supply of IPOs and the inexperience of many venture capital fund managers. Growth in the venture capital industry remained limited through the 1980s and the first half of the 1990s increasing from \$3 billion in 1983 to just over \$4 billion more than a decade later in 1994.

After a shakeout of venture capital managers, the more successful firms retrenched, focusing increasingly on improving operations at their portfolio companies rather than continuously making new investments. Results would begin to turn very attractive, successful and would ultimately generate the venture capital boom of the 1990s. Former Wharton Professor Andrew Metrick refers to these first 15 years of the modern venture capital industry beginning in 1980 as the "pre-boom period" in anticipation of the boom that would begin in

1995 and last through the bursting of the Internet bubble in 2000. The late 1990s were a boom time for the venture capital, as firms on Sand Hill Road in Menlo Park and Silicon Valley benefited from a huge surge of interest in the nascent Internet and other computer technologies. Initial public offerings of stock for technology and other growth companies were in abundance and venture firms were reaping large windfalls.

The technology-heavy NASDAQ Composite index peaked at 5,048 in March 2000, reflecting the high point of the dot-com bubble. The NASDAQ crash and technology slump that started in March 2000 shook virtually the entire venture capital industry as valuations for startup technology companies collapsed. Over the next two years, many venture firms had been forced to write-off their large proportions of their investments and many funds were significantly "under water" (the values of the fund's investments were below the amount of capital invested). Venture capital investors sought to reduce size of commitments they had made to venture capital funds and in numerous instances, investors sought to unload existing commitments for cents on the dollar in the secondary market. By mid-2003, the venture capital industry had shriveled to about half its 2001 capacity. Nevertheless, Pricewaterhouse-Coopers' Money Tree Survey shows that total venture capital investments held steady at 2003 levels through the second quarter of 2005. Although the post-boom years represent just a small fraction of the peak levels of venture investment reached in 2000, they still represent an increase over the levels of investment from 1980 through 1995. As a percentage of GDP, venture investment was 0.058% percent in 1994, peaked at 1.087% (nearly 19x the 1994 level) in 2000 and ranged from 0.164% to 0.182 % in 2003 and 2004. The revival of an Internet-driven environment (thanks to deals such as eBay's purchase of Skype, the News Corporation's purchase of MySpace.com, and the very successful Google.com and Salesforce.com IPOs) in 2004 through 2007 helped to revive the venture capital environment. However, as a percentage of the overall private equity market, venture capital has still not reached its mid-1990s level, let alone its peak in 2000. However, venture capital funds, which were responsible for much of the fundraising volume in 2000 (the height of the dot-com bubble), raised only \$25.1 billion in 2006, a 2% percent decline from 2005 and a significant decline from its peak.

Venture capitalists invested some \$6.6 billion in 797 deals in U.S. during the third quarter of 2006, according to the Money Tree Report by PricewaterhouseCoopers and the National Venture Capital Association based on data by Thomson Financial. Venture capital investment in United States companies increased in 2007 for the fourth year in a row to just under \$30

billion. While this represents a post-bubble high, it is less than one-third the total investment during the peak bubble year. In all, more than 3,200 companies received funding during the year. Of those, 1,279 received their first ever venture round of capital. While an increase in the invested capital toward the \$30 billion level raises the question of whether this exceeds a good level for the industry, there are several factors which caused increased investment in 2007. First, there are an increasing number of companies reaching maturity, also known as “later stage.” Many of these companies were founded during or just after the turn of the millennium and are now at the point of considering its exit options. The more mature companies often require larger financing rounds. Second, some of the sectors which received considerable attention in 2007 such as clean technology and medical devices tend to have larger deal sizes and these companies tend to require more capital. Third, turbulent exit markets, particularly for initial public offerings, over the past few years have caused venture capital firms to carry portfolio companies longer than in the past. The life sciences received 31% of total investment, consistent with recent years. Within life sciences, medical devices and equipment made up a larger share. Companies in five states (California, Massachusetts, Texas, Washington, and New York) made up 65% of companies receiving money and received 72% of the dollars. Venture investment focused on later stage companies with \$12.4 billion out of the \$29.9 billion total going to later stage companies. That is the highest post-bubble investment in later stage companies and the second most ever. At the same time, startup, seed, and early stage investment picked up momentum also. Corporate venture capital investment remained at post-bubble high levels. Clean technology investment received a lot of attention, and grew roughly 50% from 2006 levels. But clean technology investment was still less than 8% of total venture investment in United States companies.

Venture Capital Financing in European Countries

The origin of venture capital in UK is also traceable during the nineteenth century, when European merchant bankers and investors were helping the growth of industry in USA and in their dominions like South Africa, India and elsewhere. Prior to the 1980s, the only source of venture capital were the small business finance arms of the clearing banks, merchant banks which specialized in business agencies notably National Research and Development Corporation and the National Enterprise Board and Investors in Industry (3I) which was formerly named as the Industrial and Commercial Financial Corporation(ICFC). 3I was by far the most important of these sources of small business finance. Only 3I’s activities can be considered as ‘pure’ venture capital, i.e. investment in shares in small unquoted companies

with the expectation of capital gain. Despite the formation of Charterhouse Industrial Development in 1934 and ICFC (3I) in 1945, the venture capital was slow to develop in the UK. However, in the 1960's the venture capital industry in the UK developed through the expanded activities of 3I and other private and public sector initiative. Similarly, the British Venture Capital Association (BVCA) was created in 1982 to identify and research the issues facing the industry and to lobby the government for legislative changes to help the venture capital industry and Venture Economics Inc. which established subsidiary, Venture Economics Ltd. to provide information and research on the venture capital industry in the UK.

Europe has a large and growing number of active venture firms. Capital raised in the region in 2005, including buy-out funds, exceeded €60mn, of which €12.6mn was specifically for venture investment. The European Venture Capital Association formed in 1983 includes a list of active firms and other statistics. In 2006 the top three countries receiving the most venture capital investments were the United Kingdom (515 minority stakes sold for €1.78bn), France (195 deals worth €875m), and Germany (207 deals worth €428m) according to data gathered by Library House. European venture capital investment in the second quarter of 2007 rose 5% to 1.14 billion euro from the first quarter. However, due to bigger sized deals in early stage investments, the number of deals was down 20% to 213. The second quarter venture capital investment results were significant in terms of early-round investment, where as much as 600 million euro (about 42.8% of the total capital) were invested in 126 early round deals (which comprised more than half of the total number of deals).

Venture Capital Financing in Japan

Venture Capital Financing in Japan was mainly started in 1970s when the listing norms were relaxed along with other registration requirement of the stock exchange. In the mid 1970s, the venture capital funds were finding difficult to realize capital gains because of absence of an over the counter market. On 1st July 1975 Venture Enterprise Centre (VEC) was established by the government to overcome this problem. The formation of OTC in 1982 further added momentum to the growth of the venture capital in Japan. Japan Finance Co., Ltd. (JAFCO) was established in 1973 as a JV among Nomura Securities Co., Ltd., Nippon Life Insurance Co., and Sanwa Bank, Ltd. In 1982 JAFCO established Japan's first VC fund and in 1987 JAFCO shares start trading on OTC market. In 1996 Global Venture Capital established. In 1998 Japanese Limited Partnership Law was implemented. Similarly, establishment of Japan

Venture Capital Association was the milestone in the development of VC financing in Japan. Most famous VC firms in Japan are SBI Holdings, Chuo Mitsui Capital, JAFCO, NIF SMBC Ventures, JAIC, Mizuho capital, Tokyo Marine Capital, ORIX Capital and Mitsubishi UFJ Capital. Both “high-growth expectation” entrepreneurial activity and VC funding levels in Japan are much lower than in the US (even when adjusted for population and size of economy). Also lower than in Europe. According to the Global Entrepreneurship Monitor (GEM), Japan ranked second from last among high-income countries surveyed in terms of the prevalence rate of high growth expectation early-stage entrepreneurship during 2000 – 2006. Venture capital is available in Japan, but much of it comes from organizations affiliated with large financial institutions. Most VC-backed companies in Japan target domestic market exclusively. According to GEM, Japan ranks last among high-income countries surveyed in terms of the prevalence rate of the international orientation of its entrepreneurial ventures. According to GEM, entrepreneurship activity in Japanese VC’s depend heavily on a handful of Japanese stock exchanges for exits (and performance) of their domestic portfolio companies.

Japanese VCs invested ¥2,800 hundred million in 2,773 companies in the year ended Mar. 31, 2007. Primary exit vehicle for venture-backed companies in U.S. and Europe is the trade sale; in Japan it is the IPO (although many more IPOs in U.S. than in Europe for venture-backed companies).

Venture Capital Financing in China

In our neighboring country *China* venture capital industry started in the mid-1980s when the government decided that it should develop various high-technology industries. Due to lack of experience among government officials and venture capitalists, most of the initial efforts in this industry failed. The China New Technology Start-up Investment Company, one of the well-known venture capital firms in China, went bankrupt in 1997. Fortunately, although most of the early efforts failed, there has been a steady flow of support from the government and the private sector for the development of a venture capital industry in China. After years of sluggish development, China's venture capital industry grew rapidly in 1999 and 2000. As people gradually understand and accept the concept of knowledge economy, high-tech industries and venture capital, the venture capital industry has taken its initial form and begun its rapid development.

According to incomplete statistical data, there were 120 venture capital firms and 156 incubators in China in 2000. Beijing, Shanghai and Shenzhen are emerging as the centers of the Chinese venture capital system. The Beijing Venture Capital Company serves as a successful example of the new crop of venture capital firms. The company was established in October 1998 with registered capital of RMB 500 million. The company has performed well due to its adoption of internationally recognized rules and procedures of venture capital business, the strong local government support, the diversity of its shareholders, an optimal configuration of various resources, an excellent investment team, and a first-class R&D group. In 1999, during its first year of operation, the company posted a profit of RMB 51 million. Its profit increased to RMB 61 million for year 2000. Diverse sources of venture capital have emerged in China. In the last five years or so, the government, state-owned enterprises, private firms, public companies and non-banking financial institutions have all turned their attention to investing in high-tech companies. They compete against each other, against multinational corporations and against foreign venture capital funds for access to high-quality technology investments in China, with the latter two groups of companies possessing abundant capital and superior project evaluation capabilities. Since 1999, there has been a substantial influx of venture capital into China's information technologies (IT) industry, particularly in the areas of network and Internet infrastructure. The flow of venture capital in China is now determined by market forces and follows international trends. This recent development has reduced the systemic risk in venture investing to a lower level. In addition, the Chinese venture capital community has been actively exploring new venture capital paradigms that reflect China's needs and also the current international environment. The Chinese government has gradually embraced the concept of knowledge economy and is introducing a series of policies to encourage the development of the venture capital industry. In 1999, the State Council issued the Decision to Develop High Technology through Innovation and Industrialization. This Decision calls for the cultivation of capital markets and a venture capital regime for the development of high-tech industries. Later that year, the State Council issued Opinions on Establishing a Venture Capital Regime, which states that:

“Emerging industries and high-tech industries are the key drivers behind the growth of an information-based economy; IT, biotechnology, technologies on new materials, and advanced manufacturing technologies are the priorities of future government investment; it is necessary to establish and develop a venture capital industry to support technological innovations of small and medium enterprises (SMEs)”.

The development of a legal framework for the venture capital industry has become a priority of the government. Various policies on high-tech and venture capital industries have been introduced. In addition, a number of laws and regulations, such as the Venture Capital Law and Regulations on Start-up Funds, are under deliberation. In the meantime, efforts are made to ease the exit of venture capital through the capital markets. These initiatives demonstrate the Chinese government's resolve to develop a more hospitable environment for its nascent venture capital industry. In China, venture funding more than doubled from \$420,000 in 2002 to almost \$1 million in 2003. For the first half of 2004, venture capital investment rose 32% from 2003. By 2005, led by a wave of successful IPOs on the NASDAQ and revised government regulations, China-dedicated funds raised US\$4 million in committed capital.

Venture Capital Financing in India

The need for venture capital was first highlighted by the committee of development of small and medium entrepreneur under the chairmanship of R.S. Bhatt (popularly known as R.S. Bhatt committee) in 1972 by spotlighting on the problem of new entrepreneurs and technologists in setting up industries. The concept of venture capital was formally introduced in India in 1986-87 when the government announced the creation of a venture fund to be operated by the Industrial Development Bank of India (IDBI). The government levied a 5% cess on all know-how import payments to create the venture fund. The Industrial Credit and Investment Corporation of India (ICICI) also started venture capital activity in the same year.

VCFs in India can be categorized into the following four groups:

1. VCFs promoted by the central (federal) government-controlled development finance institutions such as TDICI by ICICI, Risk Capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.
2. VCFs promoted by the state government-controlled developmental finance institutions such as Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC) and Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC).
3. VCFs promoted by the public sector banks such as Canfina by Canara Bank and SBI-Cap by State Bank of India.

4. VCFs promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund, Credit Capital Venture Fund and Grindlay's India Development Fund.

The Reserve Bank of India, in regard to foreign exchange management act, frames the policy. The regulations of RBI for venture capital funds are that a SEBI registered venture capital fund investor can invest with the general permission of the RBI into Venture Capital Fund or Indian venture capital undertakings, according to the rules and regulations as specified by RBI notifications from time to time. In income-tax act 1962 venture capital fund consider as a pass through entity & not taxed, but income from this is taxed in investor's hand. The investment of capitalists in Indian industries in the year 2006 was US\$7.5bn across 299 deals. Venture capitalists invested some \$928 million in 80 deals for entrepreneurial companies in India since early 2008, according to Hawkins and Doyle Inc.'s Analysts statements today. This was a whopping 166% increase over the \$349 million invested in 36 deals in 2007 and easily the highest total on record for the region. The report found nearly 48% of all venture financing deals in India were for Information Technology (IT) companies, as 38 rounds were completed, accounting for \$384 million, more than India's entire 2007 venture investment total. The most popular recipients of venture capital in the IT industry were companies in the Web-heavy "information services" sector, which accounted for 22 deals and nearly \$141 million in investment. Among the deals in this area was the \$10 million second round for Bangalore-based Four Interactive, an online provider of local information on food, events, lifestyle, shopping and more.

2.3 Reviews on Nepalese Perspective

The financial liberalization process in Nepal started in 1984. Since then, various liberalization measures have been implemented in order to widen and deepen the financial system. Some policy instruments were aimed at increasing the competition and efficiency in the financial market, which included removal of entry barriers to commercial banks, finance companies and development banks in the year 1984, and restructuring of two state-owned banks. In order to improve the efficiency of money and capital markets, measures such as auctioning of Treasury Bills in the November 1988 and floor trading of securities were introduced in January, 1994. The policy instruments such as interest rate deregulation, reduction in reserve requirement and change in the monetary policy stance from direct to indirect were implemented. Similarly, introduction of prudential norms in the year 1988, establishment of

Credit Information Bureau in 1989, revision of Nepal Rastra Bank Act in 2002 which give the autonomous status to the central bank, and enactment of Debt Recovery Act in the same year were aimed at ensuring the integrity of banks and maintenance of the stability of the financial system of Nepal. All of these policy instruments were expected to complement each other in achieving the overall objectives of competition and efficiency, smooth functioning of money and capital markets, and attainment of stability in the financial sector of Nepal.

The 1990-96 period, with the restoration of multiparty, parliamentary democracy, in 1990, the investment climate changed dramatically as the democratically elected government ushered in market-orientated reforms to accelerate economic growth and opted to participate in the process of economic globalization sweeping the world's economy. Thus (a) Except on gold and silver, full convertibility of the Nepali Rupee on current accounts was introduced, (b) all quantitative restrictions and import licenses were removed, (c) tariff structure was rationalized, (d) investment incentives were extended, (e) a new Foreign Investment and Technology Act was promulgated, in 1992, that sought to provide national treatment to foreign investors, (f) the process of liberalization of the financial sector-- that had actually begun in 1984-- was further liberalized with new foreign joint venture banks, national and regional commercial and development banks entering the market coupled with a liberal policy towards entry of financial intermediaries, cooperative banks and insurance companies, (g) the central bank (NRB) removed provision for banks to have to invest in treasury bills thus freeing banks' deposits for investments by the private sector, (h) actions were being taken in earnest to simplify the tax administration by moving to a VAT regime, (i) a highly favorable treaty of trade was signed with India in 1996, and (j) the negotiations over sharing water resources with India was progressing satisfactorily.

Actually, the results of these actions speak for themselves: GDP grew from 4.8 percent per year on average during 1985-1991 to 5.2% during 1992-96. Private sector investment accelerated remarkably from 4.7% annual average growth during 1985-1991 to 13.2% during 1992-96. The growth rate in manufactured value added shot up to 13.0% on average during 1992-96 as compared to 5.3% during 1985-91. Employment in manufacturing rose by more than 36 % within a couple of years of the liberalization policies of the 1990s (World Bank-FNCCI: 2000). The period 1996-2002 may be described as the economic turnaround period. At this very moment, the CPN (Maoists) declared a 'people's war'. They struck at a most strategic period when all the gains from the new policy of liberalization had been exhausted or was in the process of being exhausted. Due to this ten years 'people war' and political

instability development process in Nepal was very slow. Nepal has had fifteen governments in the last 17 years. The People's Movement in April 2006 forced King Gyanendra to reinstate the House of Representatives, dissolved in May 2002, and relinquish the power he seized on February 1, 2005. The Seven-Party Alliance (SPA) formed a government under the leadership of Girija Prasad Koirala in April 2006. The reinstated Parliament and the government limited the powers of the King. After months of intense negotiations with the Communist Party of Nepal (Maoist), which had conducted a violent insurgency in Nepal since February 1996, the Government of Nepal and the Maoists signed a comprehensive peace agreement on November 21, 2006. Under the peace agreement, the Maoists vowed to shun violence and respect the democratic process. After promulgation of a new interim constitution and formation of an interim parliament, including representatives of the Maoists, in January 2007, and formation of an interim government with Maoist ministers in April 2007, the country was focused on a Constituent Assembly election.

The first venture capital firm was established in the year 1993 by NIDC capital market Ltd. but it was closed within short span of time. Formally, after restoration of peace, finance minister while presenting the budget of fiscal year 2007/08 in the interim parliament announced the need of venture capital in Nepal and assured the people to create conducive and legal environment for venture capital financing in Nepal. But the law has not been tabled in the parliament till date. Also in 'Three Year Interim Plan' prepared by then Seven Party Alliance (SPA) government also stated to create conducive environment for venture capital financing. So, the development of venture capital is a recent phenomenon in Nepal. It is still in an infant stage and requires promotional efforts as well as policy initiatives for a rapid growth.

In the year 2005, IT Park at Banepa was built by the Government of Nepal with the investment of Rs. 280 million for development of ICT clusters like Silicon Valley and Boston in USA but it failed due to lack of interest by private sector. In the present budget 2008-09 government has announced to develop IT park as a special economic zone. Recently, *Business Incubation Program (BIP)*, Kathmandu was established under the lead role of the Department of Cottage and Small Industries, Government of Nepal, with active support of academia, professional organizations and research institutions. BIP is a nonprofit program under the ownership of Government of Nepal but strictly operated using modern management tools as a business organization. The BIP focus on; capable science, engineering and management graduate with highly innovative business ideas from all over Nepal; innovative

but economically deprived individuals or group through assistance from a separate *central fund*; Projects which will substantially enhance the value of Nepalese indigenous products for the domestic and international market. BIP also provide financial advice, planning and solutions through specialized human resources, linkages to financial institutions, angel investors and *venture capital*.

In the year 2008 Fortune Cookie Ventures Pvt. Ltd is established. It is an international joint venture set up by successful Information and Communication Technology (ICT) entrepreneurs in Nepal and Intelligent Capital LLC, a US-based international venture capital company. Being registered as Fortune Cookie Venture (P) Ltd., the company will initially operate as an incubation centre in accordance with the government program of business incubation. The goal of Fortune Cookie Ventures Pvt. Ltd is to provide *incubation and venture capital* to deserving innovators with promising ideas in the ICT sector, and thus contribute to the overall development of ICT in Nepal. Fortune Cookie Ventures Pvt. Ltd intends to invest up to Rs. 100 million in Nepal's ICT sector over the next 2 years through its activities. By creating successful ventures, Fortune Cookie Ventures Pvt. Ltd would attract much needed foreign investment into the ICT sector. It has not started its operation till date. Some commercial and development banks are also planning to start VC financing in Nepal.

Need for Venture Capital in Nepal

- There is rapid technological development in the world now. On the one hand, Nepalese entrepreneurs have difficulties to cope with the technological change; whereas on the other hand, many industries are still running with rudimentary technology. There is an utmost need to start R & D work so as to identify new technology for existing industries as well as export oriented industries in particular have to adopt new technology to reduce cost, improve quality and bring novelty to their products. The search for the adoption of new technology requires venture capital.
- In Nepal, almost 300,000 young people enter into the labor market each year. Agriculture alone cannot absorb the new up growing labor force. The alternative source for employment generation in the enterprise sector. One of the most important requirements for the growth of enterprise is finance. Most of the banks, financial institutions, now in Nepal, are not interested in financing the new entrepreneurs because of high risk. Under this circumstance there is an urgent need for venture capital in Nepal.

- Whether considering the structure of the Nepalese industrial sector, it is dominated by industries based on imported raw materials. Resources from agriculture, forest and nature are exported in a raw form in other countries. For proper use of indigenous resources, the only sustainable industrial sector would be to develop the agro-based and forest based enterprises. But there are high risks involved in this and it also needs a long run strategy to be designed by the entrepreneurs as well as from the state. Venture capital plays a dynamic role to translate this idea into practice.
- Presently, there are many SMEs which are suffering from many problems. They are financially, technically, managerially and environmentally sick. There are large outstanding loans of the commercial and development banks with these sick industries. However, some of the sick industries can be revive and make profitable provided: (a) by changing product line, (b) management support provided by experts, (c) new equity is needed to revive sick conditions, (d) handling over the units to such persons who have necessary expertise, competence and fertile ideas.
- Although, the industrial policies in the past and present have envisioned the development of ancillary industries, it has not been very effective in practice. This is because of the dissimilar technology applied in the large and small sector. In many cases, the smaller sector is unable to upgrade the technology as required or changed by the large sector. The ancillary industries development approach has not gained success in Nepal because of socio-economic and cultural reasons also. Venture capitalists can develop this potential area.
- Products related to Nepalese arts and culture are famous and in demand abroad. Venture capital can be useful in reshaping and remodeling these items which can earn a large amount of foreign capital.
- Being a country of villages, there is a potential for sub-sector development in Nepal. People in the rural areas have financial and technological short but there is a demand for certain products from the national and/or international markets. Venture Capital schemes under the sub-sector development approach, to produce raw materials and linking the rural products to bigger companies would be a realistic approach for rural income generation and micro-enterprise development in particular and industrial development in general.

- There is need of venture capital financing to cater between domestic indigenous resources and foreign technology and market as well.

One well placed foreign agency head put Nepal's investment support as, "Many people in Nepal are making a great deal of money doing business here, so a well-seasoned foreign industrialist could do as well or better". Another, took this question a step further by highlighting, the three main comparative advantages in locating in Nepal.

1. Low cost location for investment as reflected in the factor cost of manpower, utilities and set-up costs. Nepal is estimated to be among the lowest cost location nations, for overall South Asian region.
2. It is unexplored yet that Nepal is an under industrialized country as far as investment is concerned and very attractive for competitive import substitution industries.
3. Friendly people i.e. the work environment are not 'hostile' and there is no "antagonism toward foreign investors".
4. There is continued support of private sector development by the major political parties that contested in Constituent Assembly and more liberalization policies by newly formed coalition government formed under the leadership of Maoist.

In the recent budget 2008-09, government has announced to made necessary amendments in existing industrial policy, foreign investment policy, trade policy and other related laws aiming at creating conducive and business friendly environment in the industrial sector. With a view to attracting domestic as well as foreign investment, procedures for the establishment of new business will be made simple, transparent and scientific so as to ensure a broad-based, sustainable and high growth industrial environment to be able to compete with the world economy. Government will extend necessary support for the identification, promotion and development of the products having comparative advantages in the areas such as hydroelectricity, herbal production and processing, organic farming, information technology and medicine.

Similarly regarding revival of sick industries government has created a fund of Rs. 300 million. It has announced to revive Agriculture Tools Factory of Birgunj and Hetauda Textile Mills. Also, possibility of re-operationalisation of Birgunj Sugar Factory will be pursued through technical valuation. Special programmes will be implemented to increase

productivity of the highly labor intensive Biratnagar Jute Mills and Gorakhkali Rubber Industries. But fund allocated for this is not enough.

Government has proposed to observe the Fiscal Year 2008/09 as "Alternative Energy Year" aiming at accelerating socio-economic development, improving ecological condition, and resolving the energy crisis currently facing the country by ways of wider use of alternative and renewable energy, involving community, increasing awareness and promoting development of such energy.²⁰ Megawatts of electricity will be generated in the periphery of Kathmandu Valley through Windmill on basis of Public Private Partnership mode of investment. Similarly, generation of wind energy will be expanded to other potential regions. To fetch minimum facility of lighting, 65000 small and cottage solar power systems will be installed in low-income households in the rural areas currently deprived of the electricity. A special programme will be launched so as to fetch solar light to each home of Rukum district. Similarly, 25000 biogas plants will be constructed in the potential areas, 450 solar drier/cooker, 1500 improved water turbines, and 2500 improved iron stoves and 50000 improved clay stoves will be installed. VC financing is necessary for this.

In order to provide self-employment opportunities to the youths, a Rs. 500 million "Youth Self-Employment Fund" will be established. Non-collateral, concessional periodic loans, up to Rs 200,000 from banks and financial institutions and free vocational trainings will be provided to the youths interested in carrying out self-employment activities in commercial agriculture, agro-Industries or service sector. This is the step toward VC financing by the government. But in Nepal main problem is proper implementation. Only 10-20% of program are implemented.

2.4 Concluding Remarks

Venture capital is risk financing available in the form of equity or quasi-equity. The venture capital company is essentially a financial intermediary. A venture capitalist provides management support and acts as a partner and advisor to the entrepreneur more than providing finance. Venture capital is available as early stage financing, expansion financing and acquisition financing.

The financial incubation that is provided by venture capital is vital. It is the collective responsibility of government, academic institutions, business organization, chamber of commerce, NGOs and enlightened civil society to create and grow environment of

opportunities, conducive to generation and development of innovative ideas and entrepreneurial spirit. Less developed countries need to give more attention to this task.

Even though venture capital is high risk capital, typically in the form of equity or quasi-equity, directed toward high rate of return that usually received in long term capital gain rather than dividend, it is the combination of the entrepreneurs' business skills and the venture capitalist' that provides much of the added value to the company. Venture capital companies generally provide management support in financial management, board representation, marketing device, product development and recruitment.

Venture capital activity in developed countries has been encouraged because of tax incentives and government subsidies available to venture capital funds and investors, well-developed avenues for buying and selling shares of small scale enterprises and favorable social climate and government policy for encouraging entrepreneurial activities.

Venture capital activity is just introducing in Nepal and is practiced in low portion. More specifically, venture capital is still in infancy and at introducing phase in Nepal. It is considered as practiced here in the form of foreign joint investments or Multinational Corporation.

CHAPTER THREE

RESEARCH METHODOLOGY

The research methodology adopted for the present study has been outlined in this chapter which deals with research design, sources of data, population and sample study, data gathering instruments and procedures and finally method of analysis employed in the study.

3.1 Research Design

Research design is the plan, structure and strategy of investigation conceived so as to obtain answer to research questions and to control variance (Kerlinger: 1986, P. 275). Research design refers to the entire process of planning and carrying out a research study (Wolf and Pant: 2004) keeping in mind the objectives of the study, descriptive cum analytical research design, which is a fact finding operation searching for adequate information, has been followed. Descriptive approach has been used to describe the concept of venture capital financing and analytical approach has been used mainly to depict and to analyze the situation of the VCFs.

3.2 Nature and Sources of Data

The study is primarily based on primary data. Secondary data also has been used as per necessity for the study. For the purpose of the study various journals and periodicals related to finance, books on venture capital, several published and unpublished reports, discussion papers, seminar papers, computer records and websites, manuals, status papers, thesis and dissertations and encyclopedias are the sources of secondary data. Likewise, primary data has been collected as per necessity for the purpose of the study. The primary data has been collected by means of structured or unstructured questionnaires, informal meetings, discussions, opinion and interview with financial experts etc. as per necessity for the study.

3.3 Population and Sample Study

The concept of venture capital financing is a significant innovation of twentieth century but its practice in Nepal is still in infancy. Only a few peoples have the conceptual knowledge of venture capital financing in Nepal. These include some government officials of financing and investment sector and other private parties included in financing and investment activities in banks, finance companies or business houses. Therefore the judgment random sampling

method is adopted for collecting the primary data through questionnaire. All the samples are taken from Kathmandu valley of Nepal.

In total 40 peoples including government and non-government sector were requested for making responses. Among them 32 respondents, 17 form government sector and 15 from non-government sector have provided their answers with valuable suggestions.

3.4 Data Gathering Instrument and Procedures

This study is mainly based on primary data obtained from structured questionnaire basis administered in various fields. The secondary data used here is obtained from websites of Department of Industry, Ministry of Industry, Commerce and Supplies. Besides, a detailed review of literature has been conducted in order to collect relevant data and information. Such review materials are mainly obtained from online library of TUCL and other various online libraries.

Most of the primary data are collected from structured and unstructured questionnaires on judgmental sample basis. These questionnaires as shown in annex-7 were provided by field visit and personal meetings and further discussions and queries were administered with related peoples. Total of forty questionnaires were distributed for responses. But only 80% of them were returned with full-fledged responses including 17 respondents from government sector and 15 from private sectors. Such information, data, facts and figures are processed by editing, tabulating and calculating prior to their analysis in order to reach to the final result and presented in the form of tables, figures etc.

Unstructured questionnaires and interviews were administered for the purpose of the study. The discussions are designed to extract following information:

- What is the present position of venture capital financing practices in Nepal?
- Is there need of VC financing practices in Nepal?
- The government of Nepal has lesser intention in VC financing, why?
- Is VC financing practice can be applied in SSEs and SMEs in Nepal?
- What are the problem and prospect of VC financing in Nepal?
- Suggestions to overcome the problem of VC financing
- Suggestion to popularize VC financing practices in present context of global market.

3.5 Method of Analysis

Analysis is the careful study of available facts so that one can understand and draw conclusions from them on the basis of established principles and sound logic (Cottle et al: 1988). The main purpose of analysis of the data is to change it from an unprocessed form to an understandable presentation and that consists of organizing, tabulating and performing statistical analysis (Wolf and Pant: 2006). Then the data collected and consolidated in proper form is analyzed and interpreted through best fit method of analysis.

The study, here, is mainly focused on opinion survey through questionnaire basis. Therefore, the percentage method of analysis is basically applied here. Simple averages and trend analysis is used for secondary data.

3.5.1 Ranking Method

Ranking method simply used for preferential analysis in qualitative as well as quantitative data. Here, simple ranking method is used for analyzing the preferential treatment of the available data. It is computed by simply multiplying the rank specific numbers and rank representative number. Rank representative are assigned of the highest number to the first priority and the lowest or 1 to the last. Finally highest total point is given the first rank and lowest total point represents the latest in ranking.

3.5.2 Percentage Method

Percentage method is a simple tool for analyzing the data. Under this tool, total point is assumed as 100% and each individual number is represented in proportional to the total or 100%.

It is calculated as:

Individual numbers: $X_1, X_2, X_3, X_4, X_5, \dots$

Total Points = $\sum X_i$

Percentage of $X_1 = \frac{X_1}{\sum X} \times 100\%$,

Percentage of $X_2 = \frac{X_2}{\sum X} \times 100\%$, and so on.

3.5.3 Trend Analysis

Trend analysis is the graphic representation of the data while analyzing. Here, simple trend analysis is used by calculating Three-yearly Moving Averages of the actual values.

CHAPTER FOUR

Presentation and Analysis of Data

The chapter Presentation and Analysis of Data, combines all the information or data collected in the course of research on Venture Capital. Information and data collected from primary and secondary sources are managed and analyzed to make research conclusion and recommendations.

4.1 Venture Capital Financing: Applicability and Promotional Efforts in Nepalese Context.

4.1.1 Defining the Venture Capital (VC)

VC is one of the newest concepts in investment and financial market. Although VC financing practices are widely conducted in developed countries, the LDCs are still back warded in this issue. VC is an investment usually in the form of equity, quasi-equity and sometimes debt (Straight or Conditional), made in new or untried technology or high risk venture, promoted by a technically or professionally qualified entrepreneur, where the venture capitalist (i) expects the enterprise to have a very high growth rate, (ii) provides management and business skills to the enterprise, (iii) expects medium to long-term gains and (iv) does not expect any collateral to cover the capital provided (Pandey et.al.1995)

VC Practices in Nepal still is in infancy and no more concept and practices are familiar here. So it is too much difficult task to make research on it.

The respondents of various fields including government and non-governmental, executives and non-executives were requested to make research work much more authentic.

Table No 4.1.1 Defining the Venture Capital Financings.

Factors	Government		Non-Government		Total	
	No. of Response	%	No. of Response	%	No. of Response	%
a)Seed or Start-up capital provided by Promoters	8	30.77	7	46.67	15	36.58
b) Financing provided for Expansion of Business.	4	15.38	1	6.67	5	12.20
c) Financing Provided for Technology Growth and Advancement	6	23.08	2	13.33	8	19.51
d) Financing with Management & Control.	5	19.23	3	20.00	8	19.51
e) All of Above	3	11.54	2	13.33	5	12.20
Total	26	100	15	100	41	100

Table 4.1.1 shows that more than one third or 36.58% of respondents are supportive with seed or start-up capital provide by promoter as venture capital. Each of 19.51% of people is found supportive with financing provide for technology growth and financing with management participation and control respectively in defining venture capital. It is notable that 12.20% people say venture capital financing to all of above mentioned factors.

Government and Non-Government officials are supportive in seed of start-up capital as venture capital with 30.77% and 46.67% responses respectively. Second largest responses from government officials go for financing provided for technology growth and advancement as VC with 23.08% responses. But with 20% of peoples in non-governmental sector are supportive to financing with management participation and control as VC.

From the empirical study it can be concluded that in Nepal, VC can be perceived as the early stage financing as seed and start-up financing with management participation by promoter and financing provided for techno-ventures.

4.1.2 Best fit Modalities of VC Financing in Nepal.

Venture Capital (VC) conceptually being risk finance should be available in the form of equity or quasi-equity. VC, in most of the countries, is available in three forms: equity, conditional loans and income notes. Participating debentures, partially convertible debentures and cumulative convertible preferences shares are another way of VC financing.

In Nepalese context, VC practice still in infancy and no more attentions considerations are given about modalities of funding. An empirical study is conducted in Nepalese experts and non-experts. The result is summarized in Table 4.1.2.

Table 4.1.2 Modalities of VC Financing.

Modalities of Funding	Government		Non-Government		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a) Equity Finance	8	44.44	3	20.00	11	33.33
b) Debt Finance	1	5.56	0	0	1	3.03
c) Semi-Equity	6	33.33	7	46.67	13	39.40
d) All of Above	3	16.67	5	33.33	8	24.24
Total	18	100	15	100	33	100

From the table 4.1.2 it can be concluded that in Nepal, semi-equity may be the best-fit modality of funding as venture financing. 39.40% of the people are in total support for the semi-equity as best fit mode for VC financing. Secondly, one third of views in total responses are inclined with equity financing as the best-fit modality of funding. There is no significant response for only the debt financing as the best-fit mode of VC funding only 3.03% people support to it.

Almost 44.44% government officials have views with equity as the best-fit mode of VC financing and 33.33% of them have support with semi-equity as best fit mode. On another 46.67% of Non-government officials have views with semi-equity as the best fit mode of VC financing and one-third of them support all of above mentioned modes including equity, debt and semi-equity are the best fit mode of VC financing.

In conclusion, it is revealed that for VC financing in Nepal, semi-equity type of funding is more appropriate mode.

4.1.3 Implication of VC Financing in Nepal.

Being the significant innovation of twentieth century, VC financing in developed world is most widely used now. VC financing in LDCs like Nepal is still in introductory phase.

The breakdown of the results of empirical study is presented in Table 4.1.3

Table 4.1.3 VC Financing Practice in Nepal.

Factors/Items	Government		Non-Government		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a) Most widely used	0	----	2	13.33	2	0
b) Little Practiced	11	64.71	7	46.67	18	56.25
c) Least Practiced	4	23.53	3	20.00	7	21.88
d) No practices at all	2	11.67	3	20.00	5	15.62
Total	17	100	15	100	32	100

Table 4.1.3 shows that with 56.25% of response VC activities in Nepal are little practiced following with 21.88% response in favor of least practiced in Nepal. 15.62% of people have solid views that VC activities are not practiced at all in Nepal. But no significant responses are supportive with VC practices are most widely used.

Both government and non-government sector responses are positive with VC activities are little practiced with have 64.71% and 46.67% of responses respectively.

From the study as above, it can be concluded that VC activities in Nepal are no more widely used up to now and VC financing in Nepal is still in infancy.

4.1.4 The Major Challenges in Conducting VC Financing Activities in Nepal.

VC financing activities are increasing rapidly in all over the world except LDCs. These activities where they are practiced are well performing also. In LDCs like Nepal VC practices are backward due to various difficulties like lack of adequate infrastructure development, lack of education, lack of finance and technology, lack of government policies and investment environment, etc.

Table 4.1.4 Challenges in Conducting VC Financing Practices in Nepal.

Factors	Government		Non-government		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a. Lack of market	3	10.00	0	-	3	6.82
b. Lack of government policies	4	13.33	1	7.14	5	11.36
c. Lack of technological possibility	5	16.67	0	-	5	11.36
d. Lack of high caliber entrepreneur	7	23.33	0	-	7	15.91
e. Lack of skilled & experienced personnel	4	13.33	2	14.29	6	13.64
f. All of above	7	23.34	10	71.43	17	38.64
g. More with above*	0	-	1	7.14	1	2.27
Total	30	100	14	100	44	100

*It is specified as “it is more with the social practices” by Mr. Badri Ojha, Executive Chairman, Sanima Development Bank Ltd.

Even though all of the listed factors in Table 4.1.4 are the major factors in impeding the VC practices in Nepal. According to the Table 4.1.4 almost 38.64% of people are supportive with all above mentioned factors as major challenges. Lack of high caliber entrepreneur with 15.91% response, Lack of skilled personnel with 13.64% covers the second and third position as major challenges.

Alternatively, 23.34% of government officials and 71.43% of non-government officials confirm their views to all of the mentioned factors are the major challenging factors in conducting VC activities.

More importantly, VC financing practice is more concerned with the social practices, but there is no practice of VC activities at all according to Mr. Ojha.

4.1.5 Factors that the VC Investment Performance Depends Critically On

Seeking further growth and advancement and which requires favorable investment environment, generally, makes investment. Venture capitalists also invest their funds in client enterprises seeking future growth prospects and more earning. For good

performance of such investment, various factors such as government policy and support, fund's investment policies, manager's investment strategy, hands-on management by venture capitalists, etc play the critical role.

Table 4.1.5 shows the breakdown of the observation conducted in the government and non-government officials and experts in Nepal.

Table 4.1.5 Critical Factors for VC Investment Performance.

Factors	Govt.		Non-Govt.		Total	
	No. of Res	%	No. of Res	%	No. of Res	%
a. Fund's Investment Policy	5	20.00	4	25.00	9	21.95
b. Manager's Investment Policy	5	20.00	3	18.78	8	19.51
c. Board Representation by Venture	4	16.00	1	6.25	5	12.20
d. The Govt. Policies & Support	11	44.00	8	50.00	19	46.34
Total	25	100	16	100	41	100

Table 4.1.5 shows that the government policies and support is the most critical and leading factors for venture investment performance. 50% of the people in Non-Government Sector, 44% of Government Officials and 46.34% in Total responses are supportive with this fact. Second views occupy the fund's investment policy and manager's investment strategy, which have 21.95% and 19.51% of total support. Only 12.20 percent people are confirmed mainly in board representation by Venture capitalist is one of the most critical factor for venture investment performance. Both government and non-government officials and expert support fund's investment policy and manager's investment strategy respectively are the other critical factors for venture investment performance.

4.1.6 VC Investment by Financing Type

It is assumed that VC is generally provided for new and risky ventures which have high growth potential. VC activities are not limited in new and risky business ideas but are extended to already establish industries also, which have expected high growth potential in future. More than seed and start up financing, acquisition or buyout, expansion and turnaround financing for sick industries also are considered as a scope of VC financing in these days.

In Nepalese context, how can VC financing be practiced and mobilized in new, existing industries and sick industries as well. An empirical study has been conducted to generalize the subject. The respondents were requested to rank their responses on 1 (most important) to 6 (least important) scale as to the VC financing types. Table 4.1.6 gives a breakdown of responses in modified way (See Annex 7)

Table 4.1.6 Investment by Financing Type

Financing Type		Total Points	% of Total Point	Rank
a)	Seed Financing	160	27.49	1
b)	Start-up Financing	144	24.74	2
c)	Expansion Financing	103	17.70	3
d)	Mezzanine Financing	53	9.11	6
e)	Turnaround Financing	59	10.14	5
f)	Acquisition/Buyout Financing	63	10.82	4
Total		582	100	

Table 4.1.6 shows that seed financing is the first important type of VC financing which has support of 27.49% responses and is ranked in first. Start up financing with 24.74% responses and expansion financing with 17.70% responses are ranked as second and third appropriate type of VC financing respectively. Mezzanine type financing has least responses with 9.11%.

In the choice of the respondents, the various type of the VC financing is ranked as follows to generalize the idea about VC application in Nepalese context (in order of preference):

1. Seed Financing
2. Start up Financing
3. Expansion Financing
4. Acquisition/ Buyout Financing
5. Turnaround Financing
6. Mezzanine Financing

From the above study, it can be concluded that for VC financing practice in Nepal. Seed financing and start up financing are the first two major types of financing. Then it needs to be started new ventures with conceptual phases and then in operation.

4.1.7 Priority Sector Industries/Projects for Venture Fund Investment

VC is often thought of as the early stages financing of new and young enterprises seeking to grow rapidly (Pratt: 1983). It has also come to be associated, especially in the USA, with the financing of high and new technology-based enterprises (Sagari and Guidoti: 1991); Pratt (1983) further argues that high technology is not a necessary condition for venture financing. VC financing is intermediated external investment in small and medium sized companies that offer the prospect of above average levels of investment risk (Aylward: 1998).

In LDC's like Nepal most of the industries are in infancy and it is difficult to adopt newest technologies at once. Therefore, it needs to consider the potential investment sectors in prioritized manner and develop accordingly with proper investment. Being the agrarian country, Nepal needs to give its eyes on the agriculture and agro-based industries basically. Service and communication, computer and electronics, transport and energy, consumer and industrial goods, biodiversity, etc. are the possible investment projects for the VC Investment in Nepal.

The respondents were requested to rank their responses on 1 (most important) to 9 (least important) scale as to the type of industries for VC investment, Table 4.1.7 gives a breakdown of responses in improved way (See Annex 7)

Table 4.1.7 Priority Sector Industries for Venture Fund Investment.

Industry Types		Total Points	% of Total Points	Rank
a)	Consumer Good	1789	13.07	3
b)	Industries Products	156	11.45	6
c)	Service & Communication	206	45.12	1
d)	Construction	98	7.20	8
e)	Computer & Electronics	186	13.66	2
f)	Transport & Energy	159	11.67	5
g)	Agriculture & Forestry	165	12.12	4
h)	Mine & Mine Products	70	5.14	9
i)	Medical & Biodiversity	144	10.57	7
Total		1362	100	

From the Table 4.1.7 it is revealed that service and communication sector is the most preferable for VC Operations. With 45.12% of response, it is ranked as first priority sector for VC investment in Nepal. Computer and electronics has second priority with

13.66% responses and consumer goods industries are noted as third priority sector with 13.07% of responses. Agriculture and forestry with 12.12% responses has fourth rank. Mine and Mine products industries are ranked as last number for venture investment.

According to the respondent's opinion survey as shown in Table 4.1.7, the industries are ranked as follows (in order of preference for VC investment):

- 1) Service and Communication
- 2) Computer and Electronics
- 3) Consumer Goods
- 4) Agriculture and Forestry
- 5) Transport and Energy
- 6) Industrial Product
- 7) Medical and Biodiversity
- 8) Construction
- 9) Mine and Mine Products

4.1.8 Feasible Projects for VC Operations in Nepal

Usually in developed countries, risky and high-tech, new projects with growth potential accommodated with high returns are feasible for VCF operation. But in LDCS like Nepal, New and risky projects have no guaranteed future growth and returns.

The respondents are requested to give their opinion as what type of projects many feasible in Nepalese perspective to launch venture operation. The summary of the responses is presented in Table 4.1.8 as below.

Table 4.1.8 Feasible Projects for VCF Operations in Nepal

Nature of Projects	Govt.		Non-Govt.		Table	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a) New Projects with high cost and high risk	2	11.11	2	12.50	4	11.76
b) High cost projects with collaboration of foreign affiliated institution.	10	55.56	6	37.50	16	47.06
c) Modest cost projects with collaboration of national affiliated institution.	6	33.33	8	50.00	14	41.18
d) Others	-----	-----	-----	-----	-----	-----
Total	18	100	16	100	34	100

Table 4.1.8 shows that with 47.06% of responses projects with collaboration of foreign affiliated institutions may be feasible for VC operations even if they incur high costs. Secondly 41.18% of people have views that modest cost projects with collaboration of affiliated institutions in the same country may be more feasible for VC operation. Only a few people i.e. 11.76% support high cost projects with high growth potential for VC operation in Nepal.

More than half or 55.56% of responses from the government sector are found positive with high cost projects with foreign collaboration for operating VC firms. On the other hand, responses from the non-government sector are confirmed with the modest cost projects as feasible for VC operations in Nepal. Only a nominal number of people support high cost projects as feasible projects in Nepal.

4.1.9 Type of Venture Financing in Case of SMEs in Nepal

In the developed world, most widely used venture participations are equity investments, technical collaboration, licensing, management participations and in combination of two or more. In less developed countries like Nepal, the type of venture participation may be different.

Table 4.1.9: Type of Venture Participation Preferable in Case of SMEs in Nepal

Type of Venture Participation		Govt.		Non-Govt.		Total	
		No. of Res	%	No. of Res	%	No. of Res	%
a)	Equity Investment	2	11.76	0	----	2	6.25
b)	Technical Collaboration	3	17.65	0	----	3	9.38
c)	Investment & Technical Collaboration	12	70.59	15	100	27	84.37
d)	Other	----	---	---	---	----	----
Total		17	100	15	100	32	100

Data in Table 4.1.9 shows that 84.37% in Total respondents have opinion that funds investment with technical collaboration is the most preferable venture participation in Nepalese investment and financial market. Only 9.38% and 6.25% of views are placed with technical collaboration and equity investment respectively as the more reliable type of venture participation in Nepal.

Looking separately at government sector 70.59% of people have the views at fund investment with technical collaboration is the more reliable type of venture participation. On another cent percent of non-government sector responses are inclined with the same as government officials. Their opinion also relates with funds investment with technical collaboration is the most preferable type of VC participation in Nepal. No views are found particularly in other types of venture participation like licensing, franchising etc.

4.1.10 The Potential Sectors for VC Operations

Venture Capital by its name suggests relates to new and technology oriented ideas or ventures. In begging and even now most of the VCF operations are entered in new and high tech ventures. Now with the development of global investment network and financial market, VC operations are extended to other sectors like service and non-technology sectors with profit potentialities.

Following Table 4.1.10 shows the summary of the observation relating to potential sectors for VC operations.

Table 4.1.10 Potential Sectors for VC Operations.

Investment Sectors		Govt.		Non-Govt.		Total	
		No. of Res	%	No. of Res	%	No. of Res	%
a)	New Technology Sector	11	57.89	6	31.58	17	44.74
b)	Non Technology Sector	1	5.26	----	----	1	2.63
c)	Service Sector	4	21.05	9	47.37	13	34.21
d)	All of Above	3	15.80	4	21.05	7	18.42
Total		19	100	19	100	38	100

Table 4.1.10 discloses that new technology sectors are the most potential investment sectors as venture capital operations. Around 45% of people's views are supportive with this sector. Secondly, with 34.21% peoples view service sector is another sector potential for VC operations in Nepal. 18.42% peoples view all of the mentioned areas of investment including new technology, service and non-technology sector are potential sectors for VC operations in Nepal. But only a few people 2.63% people support the non-technology sector are potential sectors for VC operations in LDC like Nepal.

More than one half of government officials have concentrated their views, as new technology sectors are the potential sectors for VC investment. 57.89% of them are supportive with this. On the other hand only 31.58% of non-government peoples accept the new technology sectors as VC investment in Nepal. But 47.37% of them view that service sectors are the most potential for VC investment in LDCs like Nepal where there is no or low possibility of adopting newest and high technology.

4.1.11 Problems Relating to Foreign Investment Promotion in Nepal

Although prior to 1990 some enterprises with foreign ownership operated in Nepal, encouragement of foreign direct investment (FDI) through official policy mechanism started only after the restoration of democracy in 1990s. The democratically elected government adopted the liberal market led economic policy in Nepal. Removal of import licenses, full convertibility of Nepalese Rupees, liberalization to open joint venture financial institutions, announcement of Foreign Investment & One Window Policy, new Foreign Investment & Technology Transfer Act etc were some of the important measures taken by Government of Nepal (GON). But the flow of FDI has

not been much encouraging so far. There are many problems responsible for non-encouragement of foreign investments. Among them underdeveloped infrastructure, small domestic market, lack of productive skills, corruption etc. are the major problems relating to attracting foreign investment in Nepal.

The respondents covering the fields of executive and non-executive and government and non-government sectors were requested for responding to the topic. They were requested to rank their responses on 5 (most significant) to 0 (no important at all) scale as to the problematic factors related to foreign investment promotion in Nepal. The Table 4.1.11 gives a summary of responses in modified way. (See Annex 7)

Table 4.1.11 Problems relating to Foreign Investment Promotion in Nepal

Problems	Total Points	% of total points	Rank
a) Undeveloped Infrastructure	158	19.20	1
b) Difficult to find local partner	89	10.81	6
c) Small domestic market	122	14.82	3
d) Bureaucratic harassment	113	13.73	4
e) Corruption	124	15.07	2
f) Lack of skilled labor	81	9.84	7
g) Frequent strikes	96	11.67	5
h) Country's landlocked position	40	4.86	8
Total	823	100	

It can be concluded from the table 4.1.11 that undeveloped infrastructure is the main problematic factor in promoting FDI, which covers 19.20% of responses and rank in first. Likewise, corruption with 15.07% of responses seems to be second relevant problematic factor and small domestic market ranks as third factor with 14.82% of total responses. Country's landlocked position is ranked as least relevant problem for FDI promotion.

From the summary table of the empirical study on the topic, the various problematic factors are ranked as follows (in order of preference from the most notable to the least notable problem).

1. Undeveloped infrastructure
2. Corruption

3. Small domestic market
4. Bureaucratic harassment
5. Frequent strikes
6. Difficult to find local partner
7. Lack of skilled labor
8. Country's landlocked position.

4.1.12 Accessibility of Skilled Managerial Staffs for VC Operation

One major factor for successful VC operations is the skill and competency of managerial staffs. It is generally accepted that VC operations are new risky and high technology oriented which require managerial expertise to cater with this risk criteria.

Table 4.1.12 presents the summary of an observation conducted in government and non-government sector with expertise views.

Table 4.1.12 Accessibility of skilled and high caliber staffs in Nepal

Terms	Govt.		Non-govt.		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a. Easily available	3	17.65	-	-	3	9.38
b. Moderately available	10	58.82	10	66.67	20	62.50
c. Hardly available	4	23.53	4	26.67	8	25.00
d. Nothing to say	-	---	1	6.67	1	3.12
Total	17	100	15	100	32	100

Table 4.1.12 represents the summary of the survey conducted on expertise sector. Table 4.1.12 shows that 62.50% of executives' views in total are supportive with moderate availability of skillful and competent managerial staffs. One fourth of experts in total have views that there are rare available of competent, skillful and challenging managerial staffs in Nepal for risky ventures management. Only 9.38% people have view in supporting with easy availability of managerial staffs.

Almost two-third of non-government officials i.e. 66.67% have supportive view with moderate availability of skillful and challenging managerial staffs and 26.67% of them have views with rare or no availability of skillful, challenging and competent

managerial staffs for risky venture operation. 58.82% of government officials are supported with moderate availability and 25.53% of them have views with scarce availability of competent staffs. 17.65% of government experts have their views on easy availability of skillful and competent staffs.

4.1.13 Government Support for Interested Private Parties to Launch VC Institutions

Government support is one of the major factors to launch any venture in any country. Government policies, laws, acts are major considerable terms in investment sector. Infrastructure developments, investment policies, security of the investments and the property rights are the major roles that the government has to play. The direct financial support to the interested private parties is the primary role that the government has to play. Other supportive roles relating to peace and security, infrastructure developments, relationships with other countries and foreign nationals, technology import and advancement, promotional activities etc. are the other significant roles that the government has to play. VC operations in Nepal are still in infancy stage that needs much more government support to launch VC institutions.

Table 4.1.13 Government Support to Launch VC Institutions in Nepal

Government support	Govt. officials		Non-govt. officials		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a. High	3	17.65	-	-	3	9.37
b. Moderate	5	29.41	5	33.33	10	31.25
c. Low	4	23.53	4	26.67	8	25.00
d. No	5	29.41	6	40.00	11	34.38
Total	17	100	15	100	32	100

Table 4.1.13 shows that with expertise view of 34.38% people, there is no government support to interested private parties to launch venture activities. 31.25% people have view with moderate government support to launch venture activities. Almost one-fourth of people have views with low government support and 9.37% people view that there is high government support to launch venture activities.

Among government officials, 29.41% of people view with each of moderate support, 23.53% of government officials are positive with low government support and a lowest percent (17.65%) of people have view with high government support.

On another, 40% of non-government officials have views with no government support, 33.33% have views of moderate support and 26.67% people have views of low government support in venture initialing practices. No views are found with high government support for venture practice in Nepal among non-government officials.

4.1.14 Strategies to Build Local Technology Capability for Competitiveness

Being less developed country, Nepal is unable to use its indigenous resources because of its financial and technological incapability. But we have various local or indigenous technologies of small scale that can be adopted locally but still shaded. How can we make these local capabilities more competitive is notable in this perspective.

A research work conducted under the subject shows following results as presented in Table 4.1.14

Table 4.1.14 Strategies to Build Technological Capabilities more Competitive

Strategies	Govt.		Non-govt.		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a) Helping hands with local entrepreneurs	7	24.14	6	20.00	13	22.03
b) Financial assistance to local entrepreneurs	3	10.34	8	26.67	11	18.64
c) Training to local entrepreneurs	10	34.48	11	36.67	21	35.60
d) Enterprising their knowledge	9	31.04	5	16.66	14	23.73
Total	29	100	30	100	59	100

Table 4.1.14 shows that more than one third (i.e. 35.06%) of people in total says that suitable training to local entrepreneur is only the strategy that builds local entrepreneur more competitive. With 27.73% of people enterprising the local entrepreneurs' knowledge is another more suitable strategy for competitiveness of local technologies. Consequently 22.03% and 18.64% of people view that helping hands with local entrepreneurs and financial assistance to them are another strategies for competitiveness of indigenous technological capabilities.

Among government official respondents 34.48% of them have supportive with the strategy of training to local entrepreneurs. Similarly with 31.04% and 24.14% of

views enterprising their knowledge and helping hands with them are other significant strategies. Only 10.34% of government respondents have views with financial assistance to local entrepreneur for building local technical capabilities more competitive.

Similarly, with 36.67% of the non-government officials' views training to local entrepreneurs is the most suitable strategy for building local technological capabilities more competitive. 26.67% of the peoples in this group are supportive with financial assistance to local entrepreneurs is more suitable strategy. Likewise, with 20% and 16.66% of peoples' views, helping hands with local entrepreneur and enterprising their knowledge is other suitable strategies in doing so.

4.1.15 Role of VC Financing in Reviving Nepalese Sick Industries

VC financing not only includes seed or startup capital to new and riskier projects which have high growth potential, it also includes development, acquisition and turnaround financing for sick industries. Turnaround financing is provided for financially and technically sick projects but which have high growth prospect in future. Now in Nepal, there are so many sick industries, especially public enterprises and they need to revive for growth and advancement of national economy.

What types of help or assistance they need to refresh in an active way, a survey is done for this purpose, which is shown as below:

Table 4.1.15 Role of VC financing in reviving Nepalese Sick Industries

Factors	Govt.		Non-govt.		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a. Financial Assistance	1	5.56	2	20.22	4	12.12
b. Managerial help or consultancy	6	33.33	3	13.33	8	24.24
c. Technology Development	1	5.56	-	-	1	3.03
d. All of above	10	55.55	10	66.67	20	60.61
Total	18	100	15	100	33	100

Table 4.1.15 reveals that almost three-fifth of people aim that all kinds of the assistances: financial, managerial and technology development can be provided as VC financing in reviving Nepalese sick industries. 24.24% of the people are supportive with managerial help or consultancy is most important factor for reviving sick

industries. The factors financial assistance and technology development includes 12.12% and 3.03% respectively of the total people.

Likewise 55.55% of government respondents and 66.67% of non-government respondents are supportive with the entire factors.33.33% of government respondents and 13.33% of the non-governments view that managerial help and consultancy may be proper way of VC financing for reconditioning sick industries. 20% of non-government and 5.56% of government respondents view that financial assistances may be proper way of VC financing in reviving and refreshing old and sick industries in Nepal.

4.1.16 Role that VC can play in Succession in WTO

Along with these days of globalization, the market now is not limited within the specified territory but spread all over the world as global market. For promoting, investing and marketing activities in competitive environment WTO is necessity of these days. VC operation activities are most contributing factors in joining hands with global investors and entrepreneurs and extending their activities worldwide. Furthermore, as a newly entered member, Nepal has to separate practices and steps for competing with global market. Thus VC practices are almost necessity for Nepalese investment and market sector.

A data is collected regarding this queries and the summary is shown as below:

Table 4.1.16 Role that VC can play in Succession in WTO

Roles	Govt.		Non-govt.		Total	
	No. of Resp.	%	No. of Resp.	%	No. of Resp.	%
a. Supportive role	17	100	15	100	32	100
b. No role	-	-	-	-	-	-
c. Nothing to say	-	-	-	-	-	-
Total	17	100	15	100	32	100

According to table 4.1.16 all of the responses are with the supportive role of VC operations in succession in WTO. There is no any view regarding no role of VC and ignorance about the topic. Cent Percent respondents support VC operations as facilitating factor in promoting investment and marketing with global competitive environment.

4.2 Trend in Foreign Direct Investment as VCF in Nepal

The practice of pure VC financing in Nepal is still in infancy now. More specifically speaking, VC practices in Nepal has not been implemented purely yet. But it is practiced in the form of joint investment or joint venture by the foreign investors with local investors in Nepal. These joint investments are especially in the form of financial assistance, managerial participation and technological collaboration. These forms of joint practices in financial and investment sectors, here, are considered as venture capital financing.

Economic reforms initiated by the Government during the last decade have changed the industrial and business environment in Nepal significantly. Today Nepalese industry and business are in the grip of a major transition. The opening up of the markets has placed them in an environment of competition. The ever growing process of globalization, the entry of multinationals into the Nepalese market, the liberalization of imports, and the shift to a buyer's market have thrown totally new demand on the business firms of the country. To accelerate the reform process, a number of policies like the Industrial Policy (1992), the Foreign Investment Policy (1992), the Privatization Policy (1994), the Trade Policy (1992), and the Labour Policy (1999) were formulated and enforced.

Although the Government of Nepal (GON) is open to foreign direct investment, implementation of its policies is often distorted by bureaucratic delays and inefficiency, political instability, pervasive corruption and persistent insecurity. At present, there are 1,336 foreign investment projects in Nepal, worth a total of approximately USD 1.85 billion according to official GON statistics. Indian ventures lead the list with 373 projects and over 43 percent of total foreign investment. The U.S. ranks second with 106 ventures and 13 percent of total foreign investment. China, Japan, South Korea, UK and Germany are also prominent.

Government policy changes over the past four years have signaled to foreign investors that Nepal is open for business. In 2005, the government opened some service sectors to foreign investment. Progress has been made in allowing private operations in some sectors that were previously government monopolies, such as telecommunications and civil aviation. Licensing and regulations have been simplified and 100-percent foreign

ownership is now allowed in some sectors. New banking institutions and a small stock exchange provide alternative sources of investment capital.

Nevertheless, significant problems remain. They include lack of direct access to seaports (currently all products imported by ship from third countries enter through Kolkata), difficult land transport, lack of trained personnel, scarce raw materials, inadequate power (especially outside the Kathmandu Valley), insufficient water supply, non-transparent and capricious tax administration, inadequate and obscure commercial legislation, difficulty in obtaining long-term visas for investors, and unclear rules regarding labor relations. Policies intended to establish a “one window policy” and simplify necessary interactions between investors and the host governments have produced few results. Furthermore, there is often a wide discrepancy between the letter of the law and the law’s implementation. Foreign investors constantly complain about complex and opaque government procedures and a working-level attitude that is more hostile than accommodating.

The government is aware of the deficiencies in Nepal’s investment climate and is slowly moving toward more investor-friendly arrangements. The Foreign Investment and Technology Transfer Act of 1992, amended in 1996, abolished the minimum capital investment requirement and eliminated significant barriers to foreign investment. The Act also now allows for foreign investment in legal, management consulting, accounting and engineering services.

Policies regarding hydropower generation have changed to open the sector to private development and the government is currently revising the Electricity Act under which hydro-power generation licenses are granted. A hydropower policy intended to simplify the licensing procedure and break the monopoly of the Nepal Electric Authority (NEA) over all aspects of generation, transmission and distribution was announced in October 2001. These policy changes were expected to boost the flow of foreign investment into the hydropower sector by involving the private sector in the generation, transmission, and distribution of power. Although a few sizable private-sector hydropower projects have either begun operation or are in the planning stages, persistent political instability and the poor security environment continue to discourage long term investment in this sector. In addition, few of the 2001 policy changes have been fully implemented. The licensing process remains lengthy and

cumbersome and the government has not yet passed the legislation necessary to unbundle the functions of the NEA and creates an independent regulatory body. Private sector development of hydropower for export has also been limited by domestic politics and the government's inability to finalize a blanket electric power trade agreement with India, the only potential market for any exportable electricity produced in Nepal.

Ever since Nepal has adopted liberal economic policies, throwing the doors open to foreign investors by making necessary policy level reforms, 45 countries have invested in 1068 projects as of 2005/06 according to DOI. Today foreign investors are looked as savers rather than exploiters. But the flow of foreign direct investment has not been much encouraging so far.

A summary sheet of annual registration as incremental trend of foreign investment project in Nepal is shown as below in Table 4.2.1.

Table 4.2.1 Foreign investment project in Nepal- Year wise

(Rs. In Millions)

Fiscal Year	No.	Total Project cost	Total Fixed Cost	Foreign Investment
Up to 15 July 1989	60	5440.00	4595.51	466.84
1989/90	30	2438.19	2139.60	398.51
1990/91	23	863.56	690.74	406.28
1991/92	38	3508.17	2902.10	597.84
1992/93	64	17886.22	16210.81	3083.67
1993/94	38	3733.23	3175.66	1378.76
1994/95	19	1627.28	1247.85	477.59
1995/96	47	10047.47	9398.54	2219.54
1996/97	77	8559.25	6692.15	2395.54
1997/98	77	5569.38	5142.32	2000.28
1998/99	50	5324.42	4380.17	1666.42
1999/2000	71	2669.09	1910.24	1417.61
2000/01	96	7917.62	6122.49	3102.56
2001/02	77	3318.53	1559.59	1209.65
2002/03	74	4921.82	3608.25	1793.77
2003/04	78	4323.74	3775.86	2764.80
2004/05	64	1801.10	1150.89	1639.52
2005/06	85	2895.70	2191.46	1558.34
Total	1068	92830.68	76880.52	28577.84

Sources: Department of Industry.

Table 4.2.1 shows, there is remarkable increment in foreign investment projects from fiscal year 1989/90 to FY 2005/06. Up to July 1989, the data shows only 60 projects with total project cost of Rs. 5440 million, total fixed cost of Rs. 4595.51 million with Rs. 466.84 million foreign investments. Now up to FY 2005/06, the data shows its total figures as 1068 projects with Rs. 92830.68 million total project cost, Rs. 76880.52 million total fixed costs and Rs. 28577.84 million foreign investments.

Following figure shows analytically the incremental growth trend of number of projects, total project cost, total fixed cost and foreign investment in association with average value calculated table as shown in Annex 6.

Figure 4.2.1 Number of Foreign Investment Project in Nepal

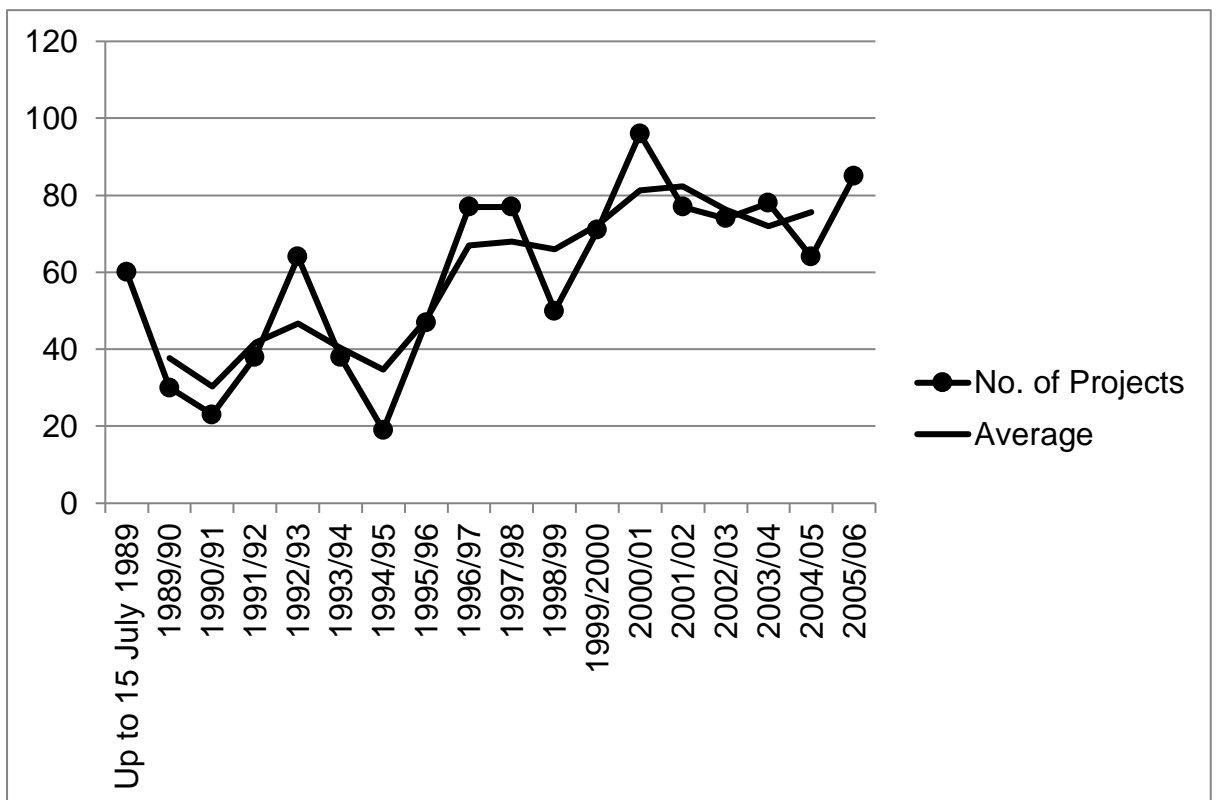


Figure 4.2.1 shows that foreign investments in Nepal are in decreasing trend from FY 1989 to FY 1994/95. The fiscal year 1994/95 has the lowest number of project registration i.e. 19 projects. Then the fluctuation started afterwards. FY 1998/99 seems lowering its trend in actual data and FY 2000/01 shows attractive increment in foreign investment projects. But trend line shows downward slopping afterwards but in FY 2005/06, it again increases.

Figure 4.2.2 Total Project Cost of Foreign Investment in Nepal

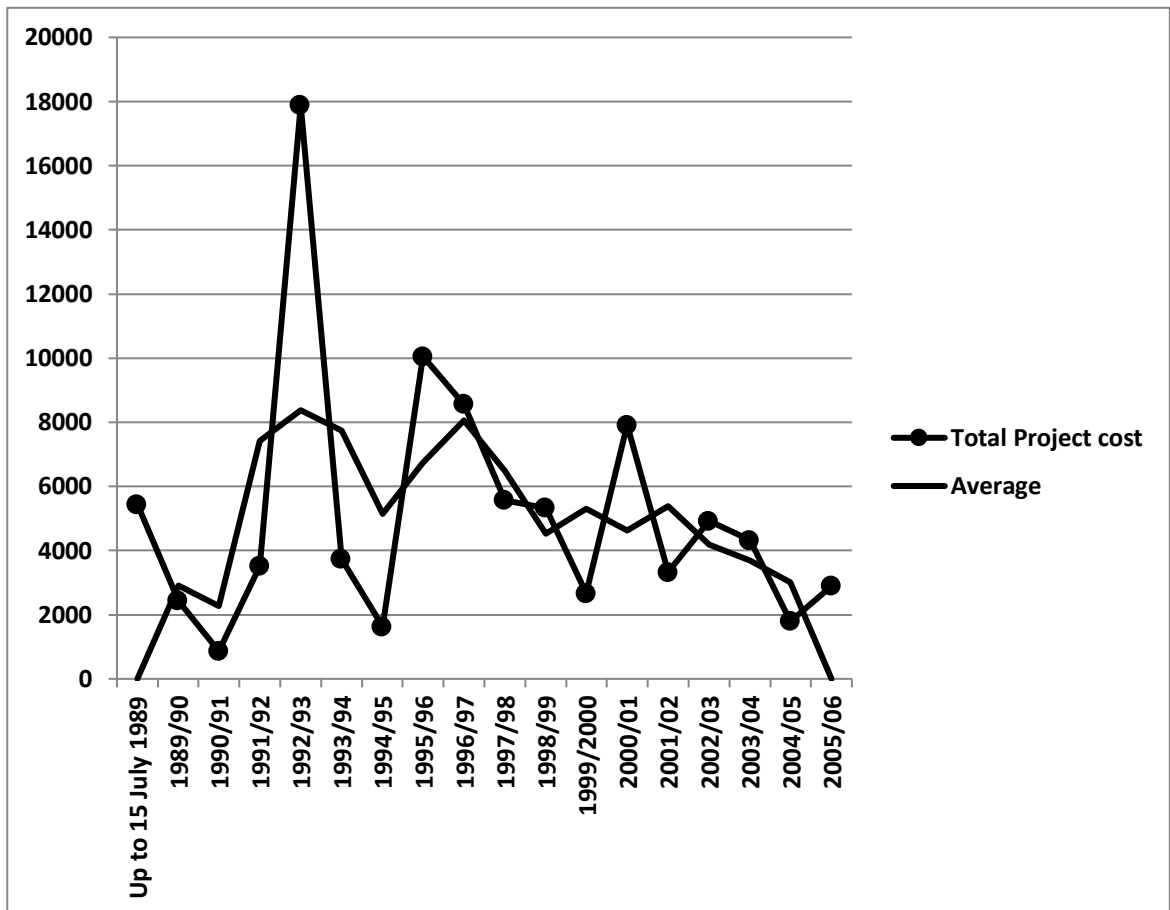


Figure 4.2.2 discloses that the trend of total project cost is unsystematically fluctuated. Line of actual data also is unsystematically passed within the period of eighteen years. FY 1992/93 seems to be best year in attracting foreign investment with total project cost of Rs. 17886.22 million and again it's started decreasing but in FY 1995/96 total project cost reaches to Rs. 10047.47 million and afterwards it again started decreasing. In average, trend line of total project cost is in decreasing trend.

Figure 4.2.3 Total Fixed Cost of Foreign Investments Projects

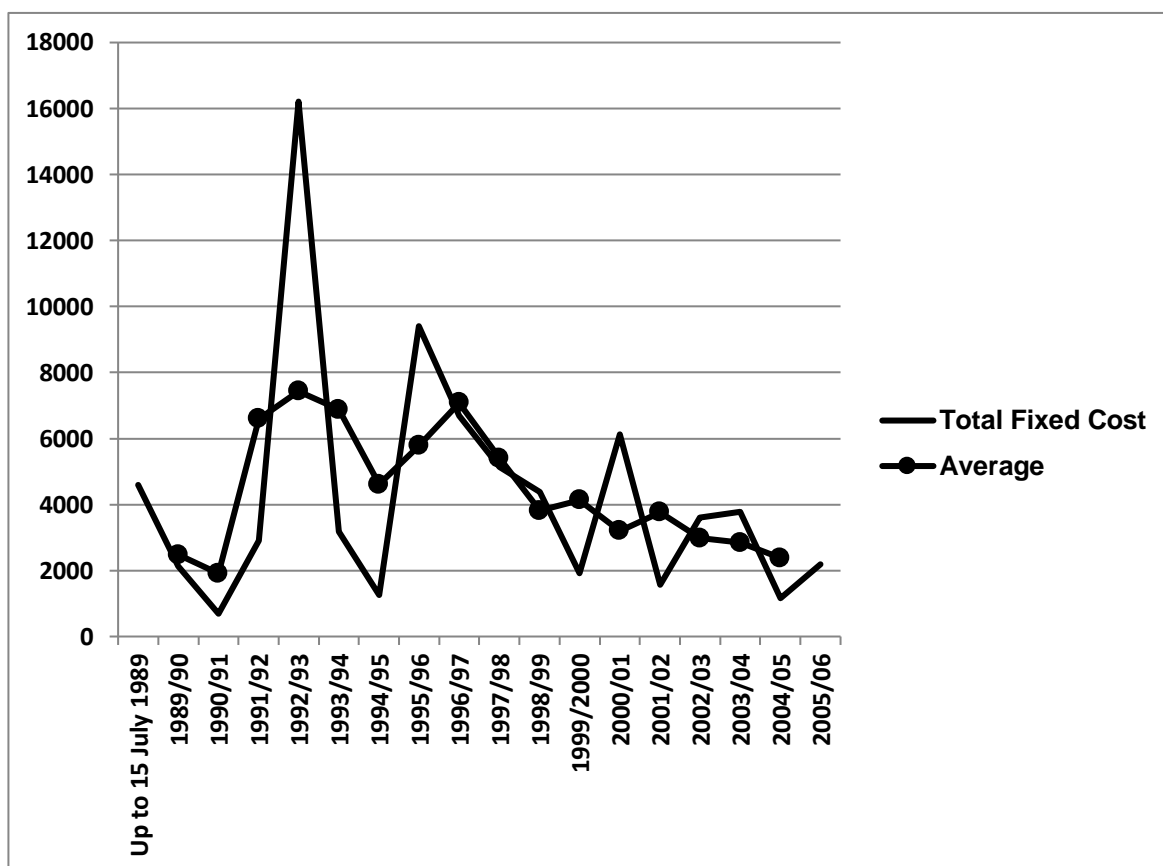


Figure 4.2.3 shows that total fixed cost of foreign investments project have fluctuating trend but in overall it is in decreasing trend. In FY 1992/93 the total fixed cost reaches the highest i.e. Rs.16210.81 million and afterwards the value started fluctuating unsystematically and shows decreasing trend.

Figure 4.2.4 Total Foreign Investments in Nepal

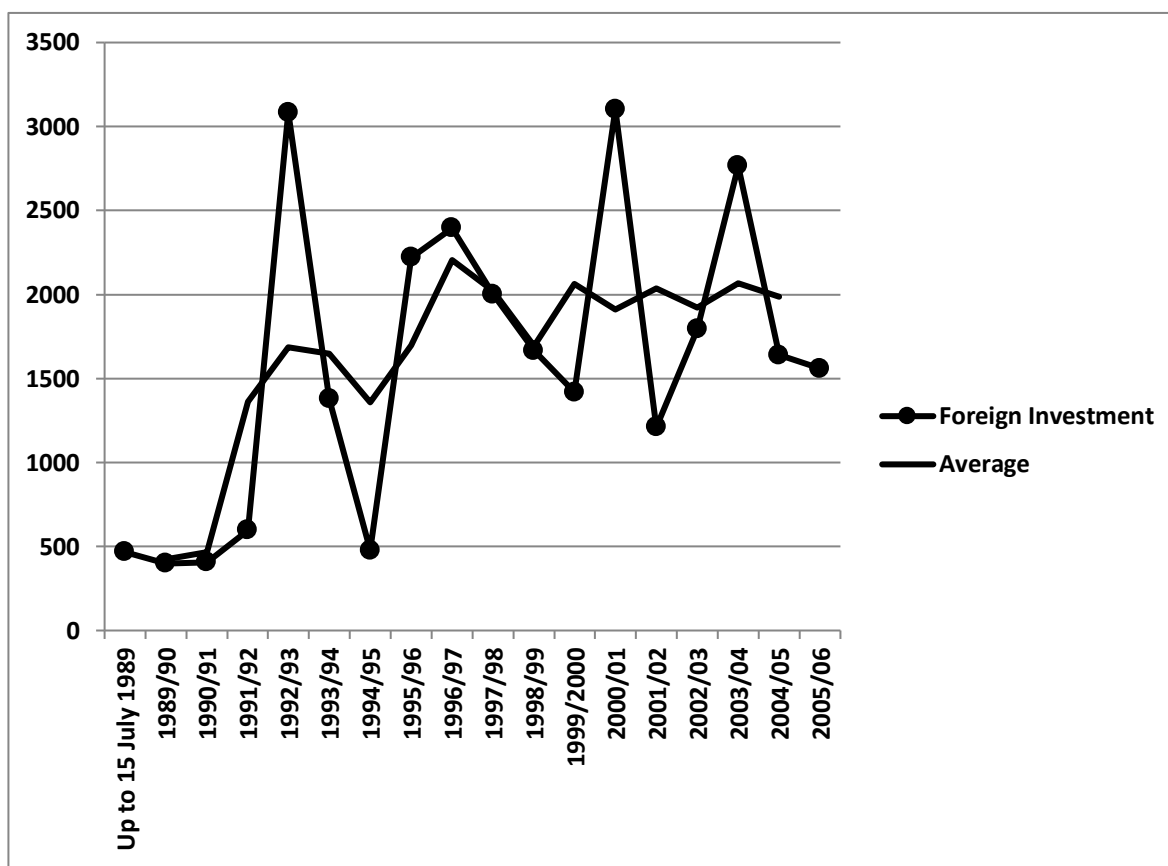


Figure 4.2.4 shows that foreign investment up in FY 1992/93, 1995/96 and 2001/02. Likewise foreign investment in actual value downs in FY 1989/90, 1994/95, 2001/02 and again it started falling after FY 2003/04.

Average line (Trend line) shows increasing trend up to FY 1992/93 and fluctuating trend with continuous ups and downs afterwards.

4.3 Policy Initiatives for the Success of Foreign Investment in Nepal

The industrial sector underwent significant changes after restoration of democracy in 1990 when the government adopted liberal, open and market oriented economic policies. Rules and regulations made to achieve faster development and the private sector is given the leading role keeping the government role as facilitator. The following arrangements are made regarding the policies governing the foreign investments:

Legislation

The most significant foreign investment laws are: the Foreign Exchange (Regulation) Act 1962; Foreign Investment and One Window Policy of 1992; the Foreign Investment and Technology Transfer Acts of 1992; the Immigration Rules of 1994; the Customs Act of 1997; the Industrial Enterprises Act of 1992; the Electricity Act of 1992; the Privatization Act of 1994 and the annual Finance Act that is passed every fiscal year.

The 1965 Patent, Design and Trademark Act and the 2002 Copyright Act define the terms and conditions of intellectual property rights protection. The Copyright Act includes all types of electronic and audio video materials, provides for financial penalties as well as imprisonment, and provides for confiscation of sold and published unauthorized materials. The offender also has to pay compensation claimed by the copyright holder. However, the revised Copyright Act is not up to the level required for trade-related intellectual property rights under the World Trade Organization. Revisions are likely, as Nepal acceded to the WTO in April 2004.

The Foreign Investment and One Window Policy of 1992 restates the desired benefits from foreign investment; lists acceptable forms of investment; allows for foreign shares up to 100 percent in business areas not on a “negative list”; establishes currency repatriation guidelines; and outlines visa arrangements, arbitration guidelines, and a special “one window committee” for foreign investors. The Foreign Investment and Technology Transfer Act (FITTA), as revised in 1996, eliminated the minimum investment requirement and clarified rules relating to business and resident visas. In general rule, under the FITTA all agreements related to foreign investment are governed by Nepalese law and subject to arbitration in Kathmandu under UNCITRAL Rules. However, foreign law can govern in cases where the foreign investment exceeds Nepali rupees (NRS) 500 million (approximately USD 7.9 million) and the parties include a choice of law provision in their agreement. The FY 2007/08 Finance Act outlines customs, duties, export service charges, sales, airfreight and income taxes, and other excise taxes that affect foreign investment. The Immigration Rules of 1994 describe visa regulations. The Customs Act and the Industrial Enterprises Act, as revised in 1997, establish invoice-based customs valuations and eliminate many investment tax incentives, installing in their place a

lower, uniform rate. The Electricity Act defines special terms and conditions for investment in hydropower development. The Privatization Act of 1994 authorizes and defines the procedures for privatization of state-owned enterprises to broaden participation of the private sector in the operation of such enterprises.

Institutional Arrangements

The Department of Industry is designated as the “one window servicing agency” with the Industrial Promotion Board (IPB) as a focal point for foreign investment under the Foreign Investment and Technology Transfer Act. The Department of Industry facilitates corporate registration, land transfers, utility connections, administrative services agreements, and coordination among various agencies. The Industrial Promotion Board (IPB), chaired by the Minister of Industry, Commerce and Supplies, is the primary government agency responsible for foreign investment. The IPB is intended to coordinate policy-level institutions, establish guidelines for economic policies approve or disapprove foreign investment proposals, and determine applicable investment incentives. The Department of Industry (under the Ministry of Industry, Commerce and Supplies) registers and classifies foreign investments. It also serves as the secretariat for the “one window servicing agency,” which manages the income tax and duty drawbacks granted to some foreign investments.

Current administrative procedures do not allow for automatic approval of foreign investments. Foreign investors are required to obtain licenses for manufacturing or service sector investments, and each license request must be considered individually. Investments below NRS 1 billion (approximately USD 15.63 million) are referred to the Department bureaucratic delays and lack of transparency in procuring investment licenses. In most cases, one to six ministries other than the Ministry of Industry review the business proposal of Industry for action and are typically approved at the Department level without the involvement of the IPB. However, investors frequently complain about and provide input prior to consideration by the IPB.

The Department of Electricity Development under the Ministry of Water Resources is the responsible agency for licensing new foreign and domestic investments in hydropower projects. However, decisions on project proposals that involve foreign investment are invariably taken by the Ministry of Water Resources itself. Similarly,

Nepal Rastra Bank (NRB), the central bank of Nepal, is responsible for issuing licenses to operate commercial banks and financial institutions. The Insurance Board (IB) is responsible for issuing licenses to operate insurance companies, both life and general. The Civil Aviation Authority of Nepal (CAAN) is responsible for granting operating licenses to both domestic and foreign airlines operators and the Nepal Telecommunications Authority (NTA) is responsible for issuing licenses for operating any type of telecommunications and information technology services.

Licensing of new investments can be time-consuming. Some foreign investors have reported that the licensing process requires a good lawyer and great patience. The law's mandate that the IPB make a licensing decision within 30 days of submission of an application is not generally implemented because of the legal proviso that all necessary information must have been submitted. In practice, multiple meetings are usually required before the information is deemed sufficient.

Eligible Sectors

Foreign investment proposals must fall under existing industry categories, which include agriculture and forestry, manufacturing, electricity (water and gas), construction, hotels and resorts, transport and communication, housing and apartments, and a restricted range of services. To comply with its WTO commitments, on December 2005 Nepal opened service industries and a few other sectors to foreign investment. This was accomplished through a GON decree amending certain provisions of the Foreign Investment and Technology Transfer Act 1992. These new sectors include business and management consulting, accounting, engineering and legal services, travel and trekking services, tourist lodging, international retail sales services, and production of alcohol or cigarettes. Foreign investment is forbidden in the defense sector and the IPB will not license foreign investments that are judged to be either hazardous to general health or the environment.

Foreign investors are permitted to acquire real estate in the name of the business entity they own, but are not allowed to acquire real estate as personal property. Although local law permits foreign investors to buy shares on the local stock exchange, in practice foreign investment in the stock exchange is not yet opened to the foreign investors. This is mainly due to the provisions of the Foreign

Investment and Technology Transfer Act 1992 which requires approval of Department of Industry for a foreigner to buy shares in a Nepalese company. Also, in cases of investment in banks and insurance companies, prior approval of the regulator is required. Further, approval of Nepal Rastra Bank is also required for such purchase of shares under the Foreign Exchange (Regulation) Act 1962. All of these hurdles make investment in the local stock market unattractive to foreign investors. Foreign investors are allowed to buy shares of government corporations by participating in the bidding for privatization of such corporations. In such cases, Nepal's Ministry of Finance sells the shares to the buyer after carrying out a lengthy screening during the bidding process. Through an amendment in the licensing policy of financial institutions, on July 26, 2006, the NRB increased the maximum foreign equity participation limit in domestic financial institutions to 85 percent from 67 percent. With the recent amendment, equity participation of foreign investors in joint venture financial institutions can range between 20 - 85 percent with the remaining shares open for purchase by the general public. Joint venture financial institutions with less than 50 percent foreign equity participation are required to earmark at least 30 percent of their shares for sale to the general public.

The Privatization Act of 1994 generally does not discriminate between national and foreign investors. However, in cases where proposals from two or more investors are identical, the government gives priority to Nepali investors. To date fifteen state-owned corporations have been privatized, seven corporations have been liquidated and two other corporations have been closed. The last privatization completed by the government was in January 2006. Out of the fifteen corporations privatized so far, foreign investors have taken over only two of them. The privatization process of three other state-owned corporations, which was underway in early 2006, is currently on hold due to major political developments after April 2006.

On April 13, 2004 the state-owned telecom operator, Nepal Telecommunications Corporation (NTC), was converted into a company and the name changed to Nepal Telecommunications Company Limited, but ownership of the company remained entirely with the government. NTC is among few state-owned enterprises that have been drawing good returns for years largely due to their historical monopolies. At the time of conversion of NTC into a company, the estimated amounts of paid-up capital and authorized capital of the corporation stood at 15 billion Nepali rupees (USD 238

million) and 25 billion Nepali rupees (USD 397 million) respectively. On January 6, 2008, the GON announced that it would sell 10 percent of NTC to the general public and 5 percent to NTC employees. The government is expected to float the shares to the public by April 2008.

Since 2003 the World Bank has been working to restructure two of the largest state-owned commercial banks, the Rastriya Banijya Bank ("National Commercial Bank" or RBB) and Nepal Bank Limited (NBL) to prepare them for privatization. However, the reform, revitalization, and professionalization of these institutions are long-term tasks and the banks are not expected to be ready for privatization until late 2009 or 2010.

Visas

The GON offers different types of visas to investors and businesses. Potential investors are generally given six-month visas to conduct research and feasibility studies. To obtain a six-month visa, applicants must provide biographic information and a description of relevant work and professional experience. If the Department of Industry can readily identify the applicant as a legitimate business representative, the process can be expedited. Endorsement by a recognized foreign industrial enterprise is one means of accomplishing this. However, the Foreign Investment and Technology Transfer Act allow a foreign investor to have only one residential representative in Nepal. In cases where the foreign investor wishes to have more than one representative, the visa process becomes difficult. In the past, investors have even had problems obtaining visas for general managers responsible the Nepalese operation.

Business visas are generally issued to approve investors for a period of one to five years. However, investors describe the business visa process as bureaucratic and time-consuming. Many say they spend more than 24 work hours per visa, over a period of 20 to 30 days.

Although the GON began issuing five-year, multiple-entry visas to resident foreign investors and their families in 1998, in actuality it has issued very few. In 1999, Nepal lowered its business visa fees; fees range from USD 250 for a five-year visa to USD 100 for a one-year visa. A non-tourist visa, however, costs USD \$60 per month for

the initial six-month period. This visa period can be extended for another six months or more at an additional \$60 per month.

Conversion and Transfer Policies

The Foreign Investment and Technology Transfer Act of 1992, permits foreign investors to repatriate all profits and dividends, all money raised through the sale of shares, all payments of principal and interest on any foreign loans, and any amounts invested in transferring foreign technology. Foreign nationals working in industry are also allowed to repatriate 75 percent of their salaries, allowances, and emoluments, etc. Repatriation facilities (such as opening accounts or obtaining permission for remittance of foreign exchange) are made available on the recommendation of the Department of Industry, which normally provides approval of the original investment.

However, convertibility is difficult and not guaranteed. Repatriation of any funds needs approval from the concerned GON department and Nepal Rastra Bank, which regulates foreign exchange. In most cases, approval must be obtained from the Department of Industry. In other cases, such as telecommunications, the Nepal Telecommunications Authority (NTA) must approve the repatriation. In joint venture cases, NRB and the Ministry of Finance must approve. Because commercial banks only process the applications but do none of the oversight, the process slows down when it reaches the NRB, which must verify the authenticity of all requests. In the end, an overworked and inefficient banking system is to blame for slow approval of foreign exchange facilities. The actual experience of American and other foreign investors suggests that there are discrepancies between the government's stated policy of repatriation and its implementation.

To repatriate funds from the sale of shares, foreign investors apply to the Nepal Rastra Bank. For repatriation of funds connected with dividends, principal and interest on foreign loans, technology transfer fees, expatriate salaries, allowances, and emoluments, the foreign investor applies to the Department of Industry, and then to the Nepal Rastra Bank. At the first stage of obtaining remittance approval, foreign investors must submit remittance requests to a commercial bank. Generally, foreign investors rated services provided by private banks as satisfactory. However, final remittance approval must be made by the NRB foreign exchange department, at which stage the process slows down significantly. For this reason, foreign investors

rated the Nepal Rastra Bank's administration of exchange regulations as unsatisfactory.

The Finance Act of FY 07/08 has added, on an exceptional basis, a 5 percent tax on capital gains and an additional 5 percent to the existing tax on repatriation of foreign dividends.

In general, Nepalese are not permitted to invest outside of Nepal. Exceptions, however, can be granted on a case-by-case basis and policing of the prohibition is weak. In 1995, a private airline was permitted to invest in a regional carrier based in Kolkata; however, the Nepalese airline stopped operation and closed down in 2005. Again, in 2006 another private airline operator formed a joint venture with a regional carrier based in India to operate flights in Northeastern states of India. During the peak of the Maoist insurgency in 2004 and 2005 a few industrial houses invested in India and Gulf countries. These represent the few instances of approved direct foreign investment by Nepalese nationals.

Expropriation and Compensation

The Industrial Enterprise Act of 1992 states that "no industry shall be nationalized." Nepal constantly reiterates this point in negotiations with private-sector firms interested in the hydropower sector. There have been no cases of nationalization in Nepal, nor are any anticipated.

Companies can be sealed or confiscated if they do not pay taxes in accordance with Nepali law. There are no official policies either existing or planned that suggest official expropriation should be of concern to prospective investors. There have been instances in the past in which unscrupulous local partners used the tax or regulatory systems to seize control of a joint venture firm from a U.S. investor. Such cases have not involved major Nepali business houses, however.

Dispute settlement

In the event of a dispute with a foreign investor, the concerned parties are encouraged to settle it through consultation in the presence of the Department of Industry. If the dispute cannot be settled in this manner, cases involving investments less than NRS

500 million (approximately USD 7.9 million) in value will be referred to arbitration in Nepal according to the Arbitration Rules of the United Nations Commission for International Trade Law (UNCITRAL). For investments that exceed this amount, the government of Nepal will permit stipulation of legal jurisdiction other than Nepal in shareholder agreements and contracts.

There have been two investment disputes over the past few years in which the GON did not honor portions of contracts with foreign investors. While the Coca-Cola Company has a pending tax dispute with the Department of Internal Revenue, the Bhotekoshi Hydropower Company, which currently has only a 5 percent U.S. stake, has a pending payment dispute with Nepal Electricity Authority and the Ministry of Water Resources. These disputes have not been frequent, but investors should be aware that the GON might not fully comply with its contracts.

All real property transactions must be registered, and property holdings cannot be transferred without following established procedures. Even so, property disputes account for half of the current backlog in Nepal's overburdened court system, and such cases can take years to settle. Moreover, laws and regulations regarding property registration, ownership and transfer are unclear, and interpretation can vary from case to case.

Liquidation is covered either by the Company Act and Insolvency Act 2006 (2063). If a company is solvent, its liquidation is covered by the Company Act. If the company is insolvent, therefore not able to pay liabilities or liabilities are more than assets, then its liquidation is covered by the Insolvency Act. Under the Company Act, the claimant priorities are: 1) government revenue, 2) creditors, and 3) shareholders. Under the Insolvency Act the government ranks with all other unsecured creditors. Monetary judgments are made in local currency.

Nepal is a signatory and adheres to the New York Convention of 1958 on the recognition and enforcement of foreign arbitral awards and has updated its legislation on dispute settlement to bring its laws into line with the requirements of that convention. The Arbitration Act of 1999 allows the enforcement of foreign arbitral awards and limits the conditions under which those awards can be challenged.

Performance Requirements/Investment Incentives

The Nepal Laws Revision Act of 2000 has eliminated most tax incentives, regardless of whether they were connected with performance requirements. Exports, however, are still favored, as is investment in certain “priority” industries. There is no discrimination against foreign investors with respect to export/import policies or non-tariff barriers. There is no local content or export performance requirement. There is no requirement that nationals own shares that the share of foreign equity is reduced over time, or that technology is transferred. However, in the service sectors, opened in 2005, permitted foreign investment limits range from 51 to 80 percent; the balance of the investment is reserved for Nepali nationals in order to form a joint venture with a foreign investor. Foreign investment in cottage industries is still not allowed. On the other hand, Nepal does employ tax incentives to encourage industries to locate outside the Kathmandu Valley due to pollution and overpopulation in the valley and an interest in developing poorer parts of the country.

Profits from exports are taxed at 20 percent. Customs, value added tax (VAT), and excise duties are to be reimbursed within 60 days on raw materials used in the production of export items. In practice, however, these duty paybacks are often extensively delayed. Although income in certain priority industries such as garments, carpets and jewelry use to be taxed at a concessional rate of 10 percent, the Income Tax Act 2002 removed most of these tax benefits and concessions.

The Electricity Act of 1992 governs foreign investments in hydropower generation. This act allows developers an exemption from income tax for the first fifteen years of a project’s operation and provides for a flat one percent customs rate on all imported construction materials, equipment and spare parts, provided that such goods are not manufactured in Nepal.

Foreign investors are not required to disclose proprietary information to government agencies as part of the regulatory approval process. There are no restrictions on participation by foreign firms in government-sponsored research and development programs; however, depending upon the nature and expertise required for the job, government agencies sometimes limit such programs to participation by Nepali nationals only.

Right to Private Ownership and Establishment

Foreigners are free to establish and own business enterprises and engage in all forms of business activity with the exception of a few industries. Prohibitions exist in the defense industry, real estate, and security printing sectors. In addition, the form of public participation is restricted in some areas. For instance, foreign banks have not yet been allowed to open wholly-owned subsidiaries or branch operations in Nepal.

The GON is moving slowly toward open competition in most sectors of the economy. Former public monopolies in banking, insurance, airline services, telecommunications and trade have already been eliminated, and the remaining restrictions on private and foreign operations in other areas are being scaled back.

The Competition Promotion and Market Protection Act 2006 came into effect on January 14, 2007. The new act defines and bars anti-competitive practices. With the enactment of the law, tied selling, bid rigging, cartel formation, collective price fixing, market restrictions, dial-system, market segregation, undue business influences, syndicate and exclusive dealing have now become illegal in the Nepal. The law also prevents companies from engaging in business takeovers which would help establish monopolies in the market. Sale of inferior quality goods has also been made punishable. The law's effectiveness is yet to be seen, at the Government has not yet established the necessary enforcement mechanisms. The Act was drafted through a joint initiative of the private sector and the Ministry of Industry, Commerce and Supplies.

Protection of Property Rights

The Contract Act of 2000 incorporates many new features, including provisions recognizing mortgages, sales, appointment of agents, and shipment of goods as contracts. Protection of intellectual property rights is inadequate. Patents registration, under the Patent, Design and Trademark Act 2002, is valid for seven years and can be extended twice for a total period of twenty-one years. Nepal does not automatically recognize patents awarded by other nations. The Copyright Act of 2002 is similar in that it does not recognize foreign registrations. However, the Act covers most modern forms of authorship and provides adequate periods of protection. Enforcement is weak, with the result that much of the software and most sound or video recordings now circulating in Nepal are pirated. As per the commitment made by the country on

its accession to the World Trade Organization, Nepal must enact new legislation on trade-related intellectual property rights to bring the country into compliance with international norms. Nepal has not yet signed the World Intellectual Property Organization (WIPO) Copyright Treaty (WCT) or the WIPO Performances and Phonograms Treaty (WPPT).

Trademarks must be registered in Nepal to receive protection. Once registered, trademarks are protected for a period of seven years. Enforcement is very poor.

Transparency of the Regulatory System

Foreign investors in Nepal face a non-transparent legal system. Firms complain that basic legal procedures are neither quick nor routine. The bureaucracy is generally reluctant to accept legal precedents. As a consequence, businesses are often forced to re-litigate issues that had been previously settled. Furthermore, legislation banning foreign investment in financial, legal, and accounting services has made it difficult for investors to find help cutting through regulatory red tape.

Labor, health, and safety laws exist but are not properly enforced. Some companies report that the process of terminating unsatisfactory employees is cumbersome and that protective labor laws make it very difficult to bring skilled foreign-national specialists such as pilots, engineers, or architects into Nepal.

Efficient Capital Markets and Portfolio Investment

Credit is generally allocated on market terms, although special credit arrangements exist for farmers and rural producers through the Agricultural Development Bank of Nepal. Foreign-owned companies can obtain loans on the local market. The private sector has access to a variety of credit and investment instruments. These include public stock and direct loans from finance companies and joint venture commercial banks.

Legal, regulatory, and accounting systems are neither fully transparent nor consistent with international norms. Though auditing is mandatory, professional accounting standards are low, and many practitioners are either poorly trained or lacking in business ethics. Under the circumstances, published financial reports are unreliable and investors are better advised to rely on general business reputations, except in the few cases in which companies have applied international accounting standards.

The Nepali banking system is small, fragmented, and, in some cases, plagued by bad loans. Banking system assets totaled approximately USD 8.13 billion on 15 July 2007, the end of Nepali FY 2006-07. Banking system capital (total deposit) in the same period totaled USD 5.93 billion. 9.65 percent of the total asset base is estimated as non-performing as of July 15, 2007. Foreign commercial lending is scarce and expensive. Currently, there are no resident or non-resident foreign commercial banks that have standing credit limits for loans of a maturity of more than one year.

There is no regulatory system to encourage and facilitate portfolio investment in the industrial sector. Lack of transparency or regular reporting of reliable corporate information also presents problems for potential foreign investors. There are no legal provisions to defend against hostile takeovers. The GON has made certain exceptions to promote Foreign Direct Investment (FDI) in tourism and hydropower. In these sectors, there can be 100 percent foreign investment. In 2008 the Clean Energy Development Bank (CEDB) has plans to establish a venture/equity fund for making investment in small and medium sized hydropower project development. The proposed “Hydro Equity Fund” would fill the early-stage financing gap for development of small- and medium-sized hydropower plants in Nepal.

Bilateral Investment Agreements

Nepal has signed bilateral investment treaties with India, Britain, Germany and Norway.

OPIC and other Investment Insurance Programs

The Overseas Private Investment Corporation (OPIC) is free to operate in Nepal without restriction. OPIC is empowered to offer its “extended risk guarantee” facility to prospective investors in Nepal. Nepal is also a member of the Multilateral Investment Guarantee Agency (MIGA), which it joined in 1993.

Labor Legislation

The Constitution provides for the freedom to establish and join unions and associations. It permits restrictions on unions only in cases of subversion, sedition, or similar conditions. Despite the institution of parliamentary democracy in 1990, trade unions are still developing their capacity to organize workers, bargain collectively, and conduct worker education programs. The three largest traditional trade unions are

affiliated with legal political parties. Total union participation is estimated to be around 900,000, which accounts for only about 10 percent of the total labor force. Excluding agriculture labor, a much higher percentage of the formal sector participates in unions.

In 1992, Parliament passed the Labor Act and Trade Union Act, and formulated enabling regulations. However, the government has not yet fully implemented those laws. The laws permit strikes, except by employees in essential services such as water supply, electricity, and telecommunications. The laws also empower the government to halt a strike or suspend a union's activities if the union disturbs the peace or adversely affects the nation's economic interests. Under the Labor Act, 60 percent of a union's membership must vote in favor of a strike in a secret ballot for the strike to be legal. The government does not restrict unions from joining international labor bodies. Several trade federations and union organizations maintain a variety of international affiliations. While officially there is no government interference in union registration, unions have complained of difficulties in registering members when opposing political parties are in power.

The Child Labor Prohibition and Regularization Act of 2000 prescribe conditions for 14- to 16-year-old laborers, and prohibit employment of children under the age of 16 from work in dangerous industries. More recent legislation, including an act to combat trafficking in persons and the interim constitution, define children as persons under the age of 18. A number of existing laws affecting child labor are in need of harmonization.

Foreign Trade Zones/Free Ports

Nepal has no Foreign Trade Zones, Free Ports or Export Processing Zones. However, any industry exporting 90 percent or more of its products is entitled to import raw materials and capital goods without payment of custom duties, excise taxes or sales taxes.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Summary and Conclusion

Entrepreneurs seek out venture capitalists for their money, and although venture capitalists seek out new ventures with high risk-return potential, they envision long-term business relationships with entrepreneurs. Venture capitalists are extremely well informed about the industries in which they invest. They frequently contact with their entrepreneurs and through their contacts, they provide access to prospective customers, suppliers and professional services. They are involved but they do not try to take over the business. Venture capitalists invest because they are reasonably convinced that entrepreneurs are capable. Occasionally they seize control when an enterprise is threatened with failure.

A venture capital firm (VCF) is a professional financing organization that provides capital for ventures and generally assists the firm's management with expertise and strategic guidance (Ogden et al). They further state that VCFs are distinguished from commercial banks and finance companies in five important aspects.

1. VCFs are partnership that obtains funds by issuing equity shares on a quasi-private basis. In contrast, most commercial banks and finance companies are public corporations and they obtain funds by issuing debt.
2. VCFs specialize in financing very young, high-risk companies, most of which are not yet profitable. In contrast, banks and finance companies generally finance relatively stable, profitable firms.
3. VCFs generally accept equity securities, rather than debt securities, in exchange for the capital they provide to a firm.
4. VCFs are much more involved in the management of a firm that they support.
5. VCFs are less regulated than either commercial banks or finance companies.

Ogden, Jen and O'Connor specify that VCF can lend their expertise in all of the following areas:

1. VCFs provide advice on compensation for key employees and building customer and supplier relations.
2. VCFs aide in the development of tactics, strategic and legal agreements.
3. VCFs provide general advice in how to manage a growing business. Generally, entrepreneurs are well equipped with technical knowledge, but few have experience in managing their own business.
4. VCFs provide access to their extensive contacts in the industry.
5. VCFs assist a venture in assembling a management team with the right skill and experience.
6. VCFs assist the venture in its search for capital.
7. VCFs consist of the venture in harvest stage, whether the firm is planning to remain private, engage a buyout, be acquired or go public.

Some of the major issues to be tackled for making Nepal an attractive for investment by domestic as well as foreign investment in various ways, viz. financial, technical, and managerial and/or in combination can be presented as follows:

- ❖ There have been significant steps in liberalization of policies, but the actual practice on the part of the government still seems to hinder investment in the economy. The lack of peace and stability, the frequent changes in government and the shifting of policies have done no good to attract investors in this country. Besides, the government functionaries including ministries and planner seem not to be clear vision about national welfare and even what they want. We need to have a national policy to which everybody adheres.
- ❖ The official policy of Nepal on investment seems to be encouraging all type of investment in all sectors all the times. In today's world of specialization and niche marketing, we need to define our territory and product and effectively market ourselves as potential destination. The country needs to identify areas where it has comparative advantage, and the investors who are likely to invest

in Nepal in a focused manner. Specific sector wise policy initiatives need to be taken.

- ❖ The declaration deed gap is another big problem. We need to make the outside world believe that we match our words with actions.
- ❖ Current administrative procedures do not allow for automatic approval of foreign investments. Foreign investors are required to obtain licenses for manufacturing or service sector investments, and each license request must be considered individually. However, investors frequently complain about bureaucratic delays and lack of transparency in procuring investment licenses. We need to change the attitude and working practices of those involved in a day-to-day decision making, if we are to attract investor to this country.
- ❖ Foreign investors come only when the investors are certain about the return, the socio-legal infrastructure as well as the image of the country as a potential destination plays an important role in their decision. So the country needs to focus on reforms in these areas also.
- ❖ The government has tried to invite investment by providing tax holidays and concessions on various duties and taxes to be paid to the government. The investors treat taxes and other expenses as mere additions to their project cost and will transfer these to the consumers of the final products. Therefore, mere fiscal incentives may not be enough to attract foreign investment. If the product is viable, the investors will come. Therefore the government needs to concentrate more on making the project viable; one way could be by minimizing risk element not associated with normal business.
- ❖ Nepal has been reiterating hydropower as its main area of comparative advantage and has been inviting private sector to invest in the country but the licensing process is too lengthy and time consuming. Some politicians in Nepal linked the investment by foreign investor in hydro-project with so called 'nationality'. So attitude should be changed and we need to tackle water related project as pure commercial propositions. We need to carry out cost-benefit analysis and decide what is to be done and what is not to be done. We have to realize that investors do not come for social service but for their own profit motives. Besides the government needs to identify viable projects and

put these before investors. The government has to take more positive step and make the decision making process more transparent. Only depending on investor's initiatives may not bring the desirable investment, especially in infrastructure.

- ❖ The other area, where Nepal offers comparative advantage is service industries including- health, education and tourism related ventures. By developing these industries we can convert our hill and mountains, which until now have been useless, into the most valued assets. But for this we may have to swallow toughest pills like allowing the foreigners to run their institutions as per the norm prescribed outside Nepal. We have to make available large tracts of land to foreign investors for potential development.
- ❖ Another tough challenge for Nepal in attracting foreign investment is human resource development. In this modern age, knowledge and technology seem to be playing more and determining role in the progress of the economy. We can easily offset all other drawbacks, if we have a competent manpower. Therefore, manpower development is the biggest challenge for attracting foreign investment.

The investment scenario in Nepal does not seem to be good. The government has not been able to make appropriate changes in the environment in spite of its loud claims. The image of Nepal in the international arena and also its location in the poorest region of the world seems to have contributed to discouraging for foreign investment. Nepal needs to carry out significant reforms in many areas for attracting foreign investment at a significant scale.

Concluding the study, one reason for not accepting the VC operations could be that the concept of venture capital in Nepal is extremely new and it has get to be fully understood or appreciated by entrepreneurs.

5.2 Findings

From this study under **Venture Capital Financing in Nepal**, the following problems are found that are faced by Venture capital practitioners;

- Lack of venture education and training
- Lack or inadequacy of fund.

- Lack of specific and stable policies regarding VC financing.
- Absence of good publicity
- Lack of Law and policies.
- Absence of good process of investment arrangements
- Lack of spontaneity toward venture financing
- Lack of entrepreneurial references
- Lack of central level organization
- Political interferences
- Lack of efficient management
- Lack of technical guidance
- Failure to interact with venture practitioners
- Dearth of sound and reliable entrepreneurs
- Lack of conformity and confidence toward venture financing
- Credibility threats
- Limited on rich and well known people and enterprises.

From this study, it is also found that financing in SSEs in Nepal has the following drawbacks:

- The equity capital provided under various schemes is inadequate and all of them have tough conditions.
- The financing is confined to low growth, low-tech ventures with minimum investment risk.
- The financing institutions are very conservative and they apply norms at early stage.
- The project appraisal takes a long time due to elaborate documentation process. Because of such delays in project evaluation, a number of enterprises and interested parties lose interest in the project and the economics of the project change.
- There is no more government policies and investment friendly environment in rural areas due to hilly region and no more infrastructure developments.

VCFs in Nepal have not very impressive flow of application both in public and private sector because;

- ✓ Concept of VC is extremely new and it has yet to be understood or appreciated by entrepreneurs,
- ✓ An avenue for risk finance is distinct from conventional financing method,
- ✓ Yet it is understood as another financial support, such as, seed capital support to the technocrats or entrepreneurs,
- ✓ Promotional efforts are not implied as per required to increase the flow of application and more specifically, to popularize the generic idea of venture financing.

Furthermore, VC financing is very difficult in Nepal for following reasons:

- It is an intangible service and not easy to convince customers about its utility.
- Requirement of an above average rate of return on investment.
- Uncertainty regarding the success of the product in the market.
- Questions regarding the infrastructure details of production like plant location, accessibility, relationship with the suppliers and creditors, transportation facilities, labor availability etc.
- The size of the market.
- Financial considerations like return on capital employed (ROCE), cost of the project, the Internal Rate of Return (IRR) of the project, total amount of funds required, ratio of owners investment (personnel funds of the entrepreneur), borrowed capital, mortgage loans etc. in the capital employed.
- It is targeted upon new technocrats or entrepreneurs whose managerial credentials are yet to be proved.

Following findings are presented based on the presentation and analysis part of the study:

1. In Nepalese context, the seed or start-up capital provided by promoter for technology growth and advancement with management participation can be perceived as Venture Capital. More than one-third of views are supported with seed or start-up capital provided by promoter and almost one-fifth of peoples

are supported in each of financing provided for technology growth and financing with management control.

2. From the study, with almost two-fifth of views, it can be concluded that equity finance sometimes supported by debt finance may be the best-fit modalities for VC financing in Nepal. It is also revealed that, most of the respondent of government sector are centered with equity finance and most of non-government respondents are in lined with semi-equity as best fit modality for VC financing in Nepal.
3. From this study, it is also found that VC practice in Nepal is not widely practiced but is in little, almost three-fifth of peoples support this.
4. With more than one-third respondents' views, it can be concluded that lack of high caliber entrepreneurs, lack of skilled and qualified personnel, lack of government policies, lack of technological possibility and lack of market and market access are the major challenges of VC practices in Nepal.
5. With almost half of responses, it can be concluded that the government policies and support is the critical factor for VC investment performance than funds' investment policy and investment strategy.
6. In Nepalese investment and financing sector, seed and start-up financing is the first and major type of financing as VC. Likewise expansion financing, acquisition financing, turnaround financing and mezzanine financing may be the other type of financing respectively as VC financing in Nepal.
7. From this study, it can be concluded that service and communication sector is the most preferable for venture fund investment. Likewise, computer and electronics is also another preferable sector for venture fund investment. It is also found that mine and mine products have least possibility for venture fund investment in Nepal.
8. From the study, it is found that high cost projects with collaboration of foreign affiliated institutions are most feasible projects for VCF operations in Nepal. Almost half of respondent are supportive to this factor. Similarly, with around two-fifth of respondents' views, modest cost projects with collaboration of national institutions is another feasible project area for VC financing activities.

But new projects with high cost and high risk are less feasible for VC financing activities in Nepalese context.

9. In Nepalese context, fund investment with technical collaboration may be the most preferable way of participation in case of SMEs in Nepal. More than four-fifth of respondents have opined this fact over other types as equity investment and technical collaboration separately.
10. It is found from this study that new technology sectors as well as service sector are potential sectors for VC operations in Nepal. More than one-third of views have supported to this fact.
11. From this study under VC financing in Nepalese context,, it is found that undeveloped infrastructure is the first and major problem for promoting foreign investment in Nepal. Likewise, corruption, small domestic market, bureaucratic harassment, lack of experienced manager, difficulty in finding local partner and lack of skilled labor are other respective problems relating FDI promotion in Nepal.
12. This is also found from the study that there is no easy availability of skillful and efficient managerial staffs for VC operations in Nepal. More than three-fifth of respondents have supportive view with moderate availability of competent, skillful and high caliber managerial staffs for VC operations in Nepal.
13. From the study, it is found that there is no ample government support for interested private parties to launch VC institutions. More than one-third peoples have opined this. On another, almost one-third of people have the opinion of moderate government support for interested private parties to VC operations.
14. This is found from the study that training to local entrepreneurs as well as enterprising their knowledge is the most suitable strategy to be local technological capabilities more competitive.
15. It is found from the study that managerial help and consultancy, financial assistance and technology development are the major role of VC financing in reviving sick industries in Nepalese context.

16. It can be concluded from the study that VC financing activities may be the most important activities for the succession in WTO with competitive global market.
17. It is found from the study that foreign investments projects, total fixed cost, total project cost and foreign investments in Nepal are in fluctuating trend with continuous ups and downs. But in overall they are in decreasing trend.
18. Policies regarding foreign investment, tax reforms, export and import, price control, transparency, technology transfer etc. are the major consideration for attracting national and foreign investors as VC participation and public private partnership.

5.3 Recommendations

Based on the findings and conclusions, some suggestions and recommendations have been put forward for overcoming the shortcomings and inefficiencies and improving the practices of VC financing.

Three basic intertwined elements underpin the creation of any commercial or other enterprise: (i) a promoter with an idea or concept, (ii) the presence of technology to support the translation of the idea or concept into a commercial product(s) or service(s); and (iii) the finance needed to underwrite the fixed capital investment and operating needs of undertaking. It will be better to consider these three elements promoter, technology and finance as a main theme for development of investment sector in Nepal. Therefore, Government of Nepal should formulate favorable policies regarding attraction of foreign investors with their ideas, finance and technology for the development of investment and production and marketing sector. Objectives relating to commercialization of ideas should be clearly defined and set for implementing ideas.

As the current and previous financial act stated it is explicit in its pledge to make preferential treatment for private sector development while encouraging the attraction of foreign capital and technology for the purpose of national development, the government should play the role of facilitator and necessary administrative and legal arrangements should be made and modified as per required.

Foreign investors do not want to jump in extremely new area for investment. Therefore, the government should assure them Nepal as a profitable hub for investment. They seek investment area having a stable political environment, positive government attitudes, favorable economic policies, low setting up costs, low-cost labors, attractive investment incentives, warm and friendly people and the location. Nepal should have been regularly monitoring these factors and functioning accordingly to attract foreign investment as well as to inspire local private investors in feasible ventures.

In determining the potential viability of an investment in Nepal, assuming that the potential foreign investor's main objective is return on his investment, both macro and micro level considerations must be addressed. The primary concerns at the macro level include degree of political stability, degree of dynamism in the market, government incentives, qualitative and quantitative aspects of labor force, supportive infrastructure including capital accessibility, alternative investment opportunities, nature of labor-management-government relationships, and extent of success stories of other foreign investors operating in Nepal.

The micro level concerns are industry related factors, i.e. inputs accessibility, process sustainability and output disposition include price and promotion. The government should introduce Nepal as peaceful and politically stable country as well as low cost location for investment. Foreign investors and local investors should be motivated in investing attractive ventures like import substitution industries. Especially, small and medium enterprises should be prioritized for venture investment indigenously. Nepalese nationals living in foreign country are interested in investing in Nepal. Creating appropriate investment environment should attract this kind of investment.

As shown in Annex 2, the DOI has listed the feasible project areas for investing in Nepal. The government should make progressive and attractive policies regarding investment and attracting more foreign investment as well as inspiring indigenous investment. It will be better to formulate project specific policies. Government should play an active role for infrastructure development and also should play a direct cum supportive role to the interested investors.

- Government of Nepal has defined the areas reserved for domestic industries, as presented in Annex-3. These industries are not granted permission for

making foreign investment. The local investment activities should be activated by inspiring potential local investors in terms of policies regarding sound investment environment, investment security, and other direct-indirect, financial-non financial facilities.

- The government also has defined the national priority industries as mentioned in Annex-4. The government of Nepal should ground its eyes on actual practice. It should grant ample facilities for motivating investment in these projects because no investor comes here only for pouring his grains in the sea but expects his nice return.
- The investment scenario in Nepal does not seem to be good. The government has not been able to make appropriate changes in the environment. The image of Nepal in the international area and also its position in the poorest region of the world seems to have contributed in discouraging foreign investors from investing in the country. Therefore, Nepal needs to carry out significant reform in many areas for attracting foreign investment at a significant scale.
- VCFs in Nepal should have a proactive strategy for identifying ventures and attracting entrepreneurs.
- It will be better to establish venture capital fund (VCF) in government sector to assist and encourage interested entrepreneurs.

Based on the study further suggestion are recommended as follows:

1. For the growth of manufacturing and service sectors, it will be better to give focus on macro-economic management by the government to improve competitiveness.
2. To improve business friendly environment efforts will have to be made to improve 'One window service' for investors along with the tax administration reform.
3. In order to reduce the cost of doing business in Nepal, improvement of physical infrastructure facilities will have to be taken into consideration with a prioritized basis.

4. It will be better to make legal infrastructure investment friendly or business friendly Industrial Enterprises Act, Foreign Investment and Technology Transfer Act, Company Act and Labor Act will have to be implemented and also processed for amendments as per requirement.
5. It will be better to liberalize all those industries for private investment which have sufficient backward and forward linkages. In this context, agro-based industries and tourism industry come into the frontline of priority. These industries have competitive investment environment and competitive advantages as well.
6. Promotion of SMEs is the need of time with global market along with the entrance in WTO, which plays the significant role in growth promotion and poverty reduction in Nepal. These small as well as medium enterprises are considered relatively more labor intensive providing employment opportunity to the people. In this way, it will be better for government to keep its eyes on focusing for the development of SMEs.
7. It will be better to create good investment environment for willing Nepalese investors sitting in the foreign countries. This type of government's role in financial and investment sector will certainly promote Nepalese economy, employment, technology and market as well.
8. The following development inputs are recommended against various constraints of potential rural entrepreneurs:
 - It will be better to give motivational inputs and share experiences of successful local entrepreneurs for self image and confidence building.
 - It will be better to create group building experiences and trustful environment.
 - It will be better to make field visit to bring market and factories for attracting industry or business activities.
 - It will be better to provide information inputs on procedures and formalities with easy access to start venture.

- It will be better to guide people with business idea and opportunity identification.
- It will be better to make market survey and project report preparation as per possibility.
- It will be better to provide orientation and training on following subjects or fields as per necessity:
 - Simple banking procedures
 - Management orientation
 - Accounting procedures
 - Technical or on-the-job training etc.

9. The following points are recommended for well practice of venture capital financing in Nepalese investment sector:

- It will be better to focus on entrepreneurs friendly policies by the nation.
- It will be better to encourage micro-enterprises in underdeveloped region.
- It will be better to encourage local youths to participate in the process of industrialization of the region by taking up entrepreneurship as a career.

10. It will be better to create attractive investment environment by the government the fiscal incentives as:

- Reduction of capital gain tax
- Preferential tax treatment to VCFs which finance eligible enterprises
- Provision of deduction of the full or a part of the cost of investment in the equity shares of VCFs from their taxable income
- Provide tax incentives to SMEs in the form of capital cost allowance, deduction of R & D expenditure, tax relief on profits
- Provision of tax exemption on dividends or capital gains of a VCF or VC funds from the equity investments in the assisted firms.

Finally, the following promotional strategies will be recommended for extensive application of VC financing concept:

1. Establishing Venture capital fund (VCF) by government.

2. Contacting R & D organizations.
3. Conducting seminar and industrials meets;
 - ✓ to present the salient features of VC schemes to the prospective entrepreneurs
 - ✓ To educate members and others about VCFs financing schemes for new and existing risky high tech business.
4. Creation of information services
5. Promotion of entrepreneurial activities;
 - ✓ Provide support for industrial potential surveys
 - ✓ Provide consultancy services
 - ✓ Provide entrepreneurial development programme (EDP)
 - ✓ Develop first generation entrepreneurs with managerial skills by establishing institutes
 - ✓ Set up science and technology entrepreneurs parks (STEPS).
6. Special marketing efforts for developing venture capital market.
7. Other development strategies:
 - i. *Venture fairs and industrial conference* for communicating entrepreneur's new ideas and business propositions and selecting high quality investment opportunities by reviewing business plan or project by venture capitalist.
 - ii. *Venture capital clubs* to increase interaction between venture capitalists and entrepreneurs.
 - iii. *Venture capital networks* to develop efficient information.
 - iv. *Venture capital associations* to take up the task of representing the interest of numerous stakeholders in the industry and of promoting them on a collaborative basis.

All above mentioned options may not be feasible at once but will be better to keep in mind by venture capitalists and policy makers as well.

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Annex 1

Essential areas to cover in your business plan

Executive Summary

This is the most important section and is often best written last. It summarizes your business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the venture capital investor will give to your detailed proposal. It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism in order to be convincing. It should be limited to no more than two pages and include the key elements of the business plan.

1. Background on the company

Provide a summary of the fundamental nature of the company and its activities, a brief history of the company and an outline of the company's objectives.

2. The product or service

Explain the company's product or service. This is especially important if the product or service is technically orientated. A non-specialist must be able to understand the plan.

- Emphasize the product or service's competitive edge or unique selling point.
- Describe the stage of development of the product or service (seed, early stage, expansion). Is there an opportunity to develop a second-generation product in due course? Is the product or service vulnerable to technological redundancy?
- If relevant, explain what legal protection you have on the product, such as patents attained, pending or required. Assess the impact of legal protection on the marketability of the product.

3. Market analysis

The entrepreneur needs to convince the venture capital firm that there is a real

commercial opportunity for the business and its products and services. Provide the reader a combination of clear description and analysis, including a realistic "SWOT" (strengths, weaknesses, opportunities and threats) analysis.

- Define your market and explain in what industry sector your company operates. What is the size of the whole market? What are the prospects for this market? How developed is the market as a whole, i.e. developing, growing, mature, and declining?
- How does your company fit within this market? Who are your competitors? For what proportion of the market do they account? What is their strategic positioning? What are their strengths and weaknesses? What are the barriers to new entrants?
- Describe the distribution channels. Who are your customers? How many are there? What is their value to the company now? Comment on the price sensitivity of the market.
- Explain the historic problems faced by the business and its products or services in the market. Have these problems been overcome, and if so, how? Address the current issues, concerns and risks affecting your business and the industry in which it operates. What are your projections for the company and the market? Assess future potential problems and how they will be tackled, minimized or avoided.

4. Marketing

Having defined the relevant market and its opportunities, it is necessary to address how the prospective business will exploit these opportunities.

- Outline your sales and distribution strategy. What is your planned sales force? What are your strategies for different markets? What distribution channels are you planning to use and how do these compare with your competitors? Identify overseas market access issues and how these will be resolved.
- What is your pricing strategy? How does this compare with your competitors?

- What are your advertising, public relations and promotion plans?

5. The management team

Demonstrate that the company has the quality of management to be able to turn the business plan into reality.

- The senior management team ideally should be experienced in complementary areas, such as management strategy, finance and marketing, and their roles should be specified. The special abilities each member brings to the venture should be explained. Concise curriculum vitae should be included for each team member, highlighting the individual's previous track record in running, or being involved with, successful businesses.
- Identify the current and potential skills gaps and explain how you aim to fill them. Venture capital firms will sometimes assist in locating experienced managers where an important post is unfilled - provided they are convinced about the other aspects of your plan.
- List your advisers and board members.
- Include an organization chart.

6. Financial projections

The following should be considered in the financial aspect to your business plan:

- Realistically assess sales, costs (both fixed and variable), cash flow and working capital. Produce a profit and loss statement and balance sheet. Ensure these are easy to update and adjust. Assess your present and prospective future margins in detail, bearing in mind the potential impact of competition.
- Explain the research undertaken to support these assumptions.
- Demonstrate the company's growth prospects over, for example, a three to five year period. • What are the costs associated with the business? What are the sale prices or fee charging structures?

- What are your budgets for each area of your company's activities?
- Present different scenarios for the financial projections of sales, costs and cash flow for both the short and long term. Ask "what if?" questions to ensure that key factors and their impact on the financings required are carefully and realistically assessed. For example, what if sales decline by 20%, or supplier costs increase by 30%, or both? How does this impact on the profit and cash flow projections?
- If it is envisioned that more than one round of financing will be required (often the case with technology based businesses in particular), identify the likely timing and any associated progress "milestones" or goals which need to be achieved.
- Keep the plan feasible. Avoid being overly optimistic. Highlight challenges and show how they will be met.

Relevant historical financial performance should also be presented. The company's historical achievements can help give meaning, context and credibility to future projections.

7. Amount and use of finance required and exit opportunities

State how much finance is required by your business and from what sources (i.e. management, venture capital, banks and others) and explain the purpose for which it will be applied.

Consider how the venture capital investors will exit the investment and make a return. Possible exit strategies for the investors may include floating the company on a stock exchange or selling the company to a trade buyer.

Annex 2

Feasible projects Areas (by DOI)

1. Medicinal and Aromatic Plants
2. Mushroom Cultivation
3. Vegetable Seed Production
4. Flower Seeds
5. Vegetable Production For Export
6. Fruit Processing
7. Tea development
8. Sericulture
9. Integrated Dairy Industry
10. Integrated Poultry Industry
11. Readymade Garments
12. Carpet Washing
13. Mineral Exploration and Exploitation
14. Floriculture
15. Textile Industry
16. Electrical and Electronic Industries
17. Pharmaceutical Industries
18. Tourist Hotels
19. Leather Goods Industries
20. Trekking and Camping Industries
21. Domestic Air Service
22. Computer Software Development and Data Entry Operations
23. Jewelry
24. Alternative Energy Production (Solar electric, heater, lamp etc.)
25. Production of Bio-diesel.

Annex 3: Industries not to be granted permission for making foreign investment or areas reserved for domestic industries

Part A	Part B
1. Cottage Industries	1. Retail Business
2. Services (Business such as Hair cutting, Beauty parlor, Tailoring, Driving training etc.)	2. Travel agencies
3. Arms and Ammunitions Industries	3. Trekking Agency
4. Gunpowder and Explosive	4. Water Rafting
5. Industries Related to Radio Active Materials	5. Pony Trekking
6. Real estate Business (excluding Construction Industries)	6. Horse Riding
7. Film Industry (National Language and other Recognized National Languages)	7. Cigarette, Bidi, Alcohol (excluding more than 90% exportable)
8. Security printing	8. Internal Courier Service
9. Currencies and Coinage business.	9. Atomic energy
	10. Tourist Lodging
	11. Poultry
	12. Fisheries
	13. Bee Keeping
	14. Consultancy Service such as management, accounting, engineering, legal service etc.

Annex 4. National Priority Industries

1. Agro and forest based industries
2. Engineering industry (Producing industrial and agricultural machinery)
3. Industries producing fuel saving and pollution control devices
4. Solid waste processing industry
5. Industry that constructs and operates road, bridge, tunnel, ropeway, flying bridge, trolley bus and tram.
6. Hospitals and nursing home (outside Kathmandu Valley).
7. Industries that produce Ayurvedic, Homeopathic and other traditional medicines as well as crutches, west belt, wheel chair, stretcher, stick etc. for the disabled and orthopedic support.
8. Cold storage established to store fruits and vegetables.

Annex 5: Industrial Policy

1. Development of Industries through healthy competition.
2. Development of industries which utilize national labor, skill and resources.
3. Acceleration of the economic development through export of manufacturing goods;
4. Emphasis on the development of small cottage and agro based industries;
5. Emphasis on attracting foreign investment and transfer of advanced technology and efficient management.

Source: "Industry and foreign Investment in Nepal: A profile on Trade Investment and Tourism, Published by Trade and Export Promotion Centre, Pulchowk.

Annex-6

Calculation of three yearly moving average of Number of Project, Total Project Cost, Total Fixed Cost and Foreign Investment

Fiscal Year	No.	Avg.	Total Project cost	Avg.	Total Fixed Cost	Avg.	Foreign Invest.	Avg.
Up to 15 July 1989	60	-	5440.00	-	4595.51	-	466.84	-
1989/90	30	37.67	2438.19	2913.92	2139.60	2475.28	398.51	423.88
1990/91	23	30.33	863.56	2269.97	690.74	1910.81	406.28	467.54
1991/92	38	41.67	3508.17	7419.32	2902.10	6601.22	597.84	1362.6
1992/93	64	46.67	17886.22	8375.87	16210.81	7429.52	3083.67	1686.76
1993/94	38	40.33	3733.23	7748.91	3175.66	6878.11	1378.76	1646.67
1994/95	19	34.67	1627.28	5135.99	1247.85	4607.35	477.59	1358.63
1995/96	47	47.67	10047.47	6744.67	9398.54	5779.51	2219.54	1697.56
1996/97	77	67	8559.25	8058.7	6692.15	7077.67	2395.54	2205.12
1997/98	77	68	5569.38	6484.35	5142.32	5404.88	2000.28	2020.75
1998/99	50	66	5324.42	4520.96	4380.17	3810.91	1666.42	1694.77
1999/2000	71	72.33	2669.09	5303.71	1910.24	4137.63	1417.61	2062.2
2000/01	96	81.33	7917.62	4635.08	6122.49	3197.44	3102.56	1909.94
2001/02	77	82.33	3318.53	5385.99	1559.59	3763.44	1209.65	2035.33
2002/03	74	76.33	4921.82	4188.03	3608.25	2981.23	1793.77	1922.74
2003/04	78	72	4323.74	3682.22	3775.86	2845	2764.80	2066.03
2004/05	64	75.67	1801.10	3006.85	1150.89	2372.74	1639.52	1987.55
2005/06	85	-	2895.70	-	2191.46	-	1558.34	-
Total	1068		92830.68		76880.52		28577.84	

Source: Department of Industry, **Website:** www.doind.gov.np

Annex-7

Calculation of the points offered for ranking criteria

i) VC Investment by financing type in Nepal

Type of Financing	(1) x 6 + (2) x 5 + (3) x 4 + (5) x 2 + (6) x 1 = Total points
a) Seed	(20x6) + (8x5) = 160
b) Start up	(8x6) + (18x5) + (1x4) + (0x3) + (1x2) = 144
c) Expansion	(2x5) + (16x4) + (9x3) + (1x2) = 103
d) Mezzanine	(2x4) + (10x3) + (0x2) + (15x1) = 53
e) Turnaround	(2x4) + (6x3) + (14x2) + (5x1) = 59
f) Buyout/Acquisition	(7x4) + (2x3) + (11x2) + (7x1) = 63
Total	582

Note: Total points are the product of rank specific nos. and rank representative number. Rank representative are assigned as 6 to the first priority and 1 to the last respectively.

(ii) Priority Sector Industries/ Projects for Venture Fund Investment

Industry type	$1 \times 9 + 2 \times 8 + 3 \times 7 + 4 \times 6 + 5 \times 5 + 6 \times 4 + 7 \times 3 + 9 \times 1 =$ Total Points
a. Consumer goods	$4 \times 9 + 5 \times 8 + 6 \times 7 + 4 \times 6 + 2 \times 5 + 2 \times 4 + 2 \times 3 + 4 \times 2 + 4 \times 1 = 178$
b. Industrial products	$5 \times 9 + 4 \times 8 + 2 \times 7 + 4 \times 6 + 4 \times 5 + 2 \times 4 + 3 \times 3 + 2 \times 2 + 0 \times 1 = 156$
c. Service & Communication	$5 \times 9 + 6 \times 8 + 11 \times 7 + 1 \times 6 + 4 \times 5 + 2 \times 4 + 0 \times 3 + 1 \times 2 + 0 \times 1 = 206$
d. Construction	$0 \times 9 + 0 \times 8 + 1 \times 7 + 0 \times 6 + 4 \times 5 + 8 \times 4 + 8 \times 3 + 6 \times 2 + 3 \times 1 = 98$
e. Computer & Electronics	$9 \times 9 + 1 \times 8 + 1 \times 7 + 6 \times 6 + 6 \times 5 + 2 \times 4 + 4 \times 3 + 2 \times 2 + 0 \times 1 = 186$
f. Transport & Energy	$1 \times 9 + 2 \times 8 + 2 \times 7 + 9 \times 6 + 8 \times 5 + 4 \times 4 + 2 \times 3 + 2 \times 2 + 0 \times 1 = 159$
g. Agriculture & Forestry	$6 \times 9 + 6 \times 8 + 1 \times 7 + 3 \times 6 + 2 \times 5 + 2 \times 4 + 2 \times 3 + 6 \times 2 + 2 \times 1 = 165$
h. Mine & Mine products	$1 \times 9 + 0 \times 8 + 3 \times 7 + 1 \times 6 + 0 \times 5 + 2 \times 4 + 0 \times 3 + 4 \times 2 + 18 \times 1 = 70$
i. Medical & Biodiversity	$0 \times 9 + 7 \times 8 + 4 \times 7 + 1 \times 6 + 0 \times 5 + 6 \times 4 + 8 \times 3 + 2 \times 2 + 2 \times 1 = 144$
Total	1362

Note: Total points are the sum of the product of rank representative number and the rank specific responses. Rank representative numbers are assigned as 9 to the first priority to 1 to the last.

(iii) Problems Relating to Foreign Investment Promotion in Nepal.

Factors	$(5)x6+(4)x5+(3)x4+(2)x3+(1)x2+(0)x1$ = Total Points
a. Undeveloped Infrastructure	$17x6+6x5+0x4+8x3+1x2+0x1$ = 158
b. Difficult to find local partner	$4x6+3x5+9x4+1x3+2x2+7x1$ = 89
c. Small Domestic Market	$5x6+9x5+11x4+0x3+0x2+3x1$ = 122
d. Bureaucratic Harassment	$8x6+2x5+4x4+10x3+3x2+3x1$ = 113
e. Corruption	$9x6+5x5+4x4+4x3+8x2+1x1$ = 124
f. Lack of skilled labor	$0x6+2x5+5x4+8x3+11x2+5x1$ = 81
g. Frequent strikes	$3x6+2x5+5x4+10x3+7x2+4x1$ = 96
h. Country's landlocked position	$0x6+0x5+3x4+2x3+4x2+14x1$ = 40
Total	823

Note: Total points are the sum of the products of the number of responses and the rank representative number. The representative numbers for rank are assigned as 6 for the most important and 0 to the least important respectively.

Annex 8

Venture Capital Financing in Nepal (Questionnaires)

Dear Sir/Madam,

The researcher, Mr. Sanjay Yadav, is going to conduct a research work entitled "Venture Capital Financing in Nepal" in partial fulfillment of the requirement for the degree of MBS from National Campus for Business Studies. I anticipate your valuable suggestions for the completion of this research work. It will be so much appreciable if you provide some of your busy and valuable time in responding this questionnaire. Your precious suggestions will be so much important for completion of this research work. I expect your responses as soon as possible. I want to assure you that the information collected from this questionnaire are only used for research work and kept confidential.

Please tick your answer if the question is provided with the alternatives and put it order of preference, if the questions require rank or preference order.

Name of the respondent:

Post: Office:

1. How could you conceptualize a venture capital financing in Nepalese perspective?

- a) Seed or start-up capital provided by the promoter.
- b) Financing provided for expansion of business.
- c) Financing provided for technology growth and advancement.
- d) Financing with management participation and control.

2. What may be the best fit modalities of venture capital financing in Nepal?

- a) Equity finance
- b) Debt finance
- c) Semi-equity
- d) All of above.

3. How can we perceive about the implication or practice of venture capital financing in Nepal?

- a) Most widely used
- b) Little practice
- c) Least practice
- d) No practice at all

4. What are the major challenges in conducting venture capital financing activities in Nepal?

- a) Lack of market and market access.
- b) Lack of government policies and support.
- c) Lack of technological possibility and practicability
- d) Lack of high caliber entrepreneur
- e) Lack of skilled and experienced personnel
- f) All of above

5. Which of the following factors the investment performance depends critically on?

- a) Fund's investment policies
- b) Manager's investment strategy
- c) Board representation by the venture capitalist
- d) The government policies and support

6) How can we distribute the investment by financing stage? Please rank the following by considering priority concern with reference to Nepal.

- a) Seed financing []
- b) Start-up financing []
- c) Expansion financing []
- d) Mezzanine financing []
- e) Turnaround financing []
- f) Buyout financing []

7) Which may be the priority sector industry for venture fund investment? Please rank the following according to your own view.

- a) Consumer goods []
- b) Industrial products []
- c) Service and communication []
- d) Construction []
- e) Computer and electronics []
- f) Transport and energy []
- g) Agriculture and forestry []
- h) Mine and Mine products []
- i) Medical and biodiversity []

8) VC operations, as practiced in the developed world, are very risky, and what makes them worthy are the very high returns captured in a few deals that turn out extremely successful, but developing world economies which are small, slow growing and inward oriented may not provide opportunities for such high returns. In such a way which alternative(s) may be reliable in your opinion?

- a) Extremely new projects with high cost and high risk.
- b) Projects at higher cost and from the collaboration of affiliated institutions operating in the foreign country.
- c) Projects at modest cost and from the collaboration of affiliated institutions operating in the same country.
- d) If other please specify

9) Which of the following type of participation is more preferable in venture capital financing in case of SMEs in Nepal?

- a) Equity investment
- b) Technical collaboration
- c) Investment and technical collaboration
- d) Other than above.

10) The initial success of VC industry was mostly anchored in technologically innovative enterprises but VC in the developed world has now begun to focus on the service area. In the context of LDCs markets like Nepal, which of the following may have the potential for VC operations?

- a) New technology sector
- b) Non technology sector
- c) Service sector
- d) All of above

11) How would you rank the following problems in relation to foreign investment promotion in Nepal? Please rank 0 to 6 in each of the problems giving 6 to the most important and 0 to the no problem at all.

- a) Undeveloped infrastructure []
- b) Difficult to find local partner []
- c) Small domestic market []
- d) Bureaucratic harassment []
- e) Corruption []
- f) Lack of skilled labours []
- g) Frequent strikes []
- h) Country's landlocked position []

12) In what extent it is easy to access skillful, competent and high caliber staffs with managerial potential in Nepal?

- a) Easily available
- b) Moderately available
- c) Hardly available
- d) Nothing to say

13) In which extent has the government of Nepal played the major and supportive role for interested private parties to launch VC institutions?

- a) High
- b) Moderate
- c) Low
- d) No

14) How can we suggest for strategies by Nepal to build local technological capabilities for competitiveness?

- a) Helping hands with local entrepreneurs
- b) Providing financial assistance to local entrepreneurs
- c) Training to local entrepreneurs relating to technology transfer
- d) By encouraging them in enterprising their knowledge

15) What role(s) that VC financing can play for reviving Nepalese sick industries?

- a) Financial assistance
- b) Managerial help or consultancy
- c) Technology Development
- d) All of above

16) Along with these days of globalization, Nepal is going to enter in WTO, what role that VC can play to compete with international products and markets in the case of Nepalese investment and marketing sector?

- a) Supportive role
- b) No role
- c) Nothing to say

Finally, your comments and suggestions concerning the efforts that Nepal should make for the promotion of venture financing and foreign investment and technical collaboration.

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